

MAKING GOVERNMENT ACCOUNTABLE

LOCAL GOVERNMENT AUDIT IN POSTCOMMUNIST EUROPE

edited by
Kenneth Davey



Making Government Accountable

Local Government Audit in Postcommunist Europe

Edited by

KENNETH DAVEY



Local Government
and Public Service
Reform Initiative

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Local Government Audit in Eastern Europe

Kenneth Davey

An effective system of audit is crucial to the integrity and efficiency of local government. Making it work depends on a variety of factors: the legal framework, the scope of issues and operations covered, and the quality of professional resources employed. Finally, elected representatives, civil society organizations, and local media must have access to the audit findings, understand their significance, and take a real interest in them.

Audit is essential to the workings of an open society. LGI is, accordingly, concerned that audit should develop concurrently with other aspects of public administrative reform in transition countries. To this end, it commissioned reports on the status of local government audit in thirteen East European countries during 2007. The countries covered were: Albania, Armenia, Azerbaijan, Bosnia and Herzegovina, Croatia, Georgia, Macedonia, Moldova, Montenegro, Romania, Russia, Serbia, and Ukraine.

Following is a brief summary of the reports that are reproduced in the body of this volume. The summary also reflects a consultation with the authors in Kiev, Ukraine, in February 2008. The volume is intended to stimulate discussion on initiatives which LGI and other agencies could take to promote improvements in laws, capacity, and practice.

EXTERNAL AUDIT

Legal Requirements

In comparing the 13 countries, external audit is variously exercised by:

- National audit institutions examining local budgets in full;
- National audit institutions scrutinizing the expenditure of earmarked state budget subsidies only; or
- Private audit companies operating commercially.

In Bosnia and Herzegovina, Croatia, Macedonia, Romania, and Serbia, local governments are subject to comprehensive audit by the national audit organizations answerable to their individual parliaments. These are states which possess or aspire to EU membership and the arrangement arises from recent reforms designed to conform with *l'acquis communautaire*. In Montenegro and Serbia, local councils may also commission parallel audits by commercial firms. Similar provisions exist in Moldova.

In Russia and Ukraine the federal/national and republican/oblast audit chambers have powers to audit use of State Budget-earmarked subsidies but not “own revenue.”

There is also a vertical system of financial control within the executive hierarchy of their finance departments. In Ukraine this is assumed by the Chief Accounting and Audit Department of the Ministry of Finance (CCAD), which scrutinizes local budgets in full. In Georgia, state audit only covers the use of earmarked grants, and elected council finance commissions are supposed to undertake or commission audit of the budget-execution reports. A similar provision is made in Armenia, though state audit extends to non-earmarked transfers, which effectively involves scrutinizing all expenditure, since the source of funding cannot be distinguished.

In Azerbaijan, the national Chamber of Accounts may conduct an audit of an individual local government at the request of the Ministry of Justice, in order to investigate a specific complaint or suspicion of financial irregularity. Otherwise, local governments are required to arrange commercial audit of their budget-execution reports.

The Practice

In several instances external audit is less satisfactory in practice than in law. The following are examples of apparently inadequate coverage:

- *Armenia*: an average of 24 out of 926 local governments are audited annually.
- *Bosnia and Herzegovina*: coverage of the Federation municipalities by the Audit Office has declined from 18 in 2002, to one in 2006.
- *Montenegro*: two out of 21 municipalities have been audited to date.
- *Romania*: 84 out of 7,455 budget-execution reports were audited in 2006.
- *Serbia*: the State Audit Institution has not yet been constituted by Parliament.

A rotating national audit covers approximately one third of local government units in Croatia and Macedonia, and one half in Republika Srpska. In Georgia, the reorganized municipalities only commenced financial operations in 2007.

In Georgia and Serbia, institutional arrangements for audit are new and their adequacy remains to be proven. Inadequacy elsewhere has been ascribed to the time and cost involved in deploying sufficiently qualified staff and, in countries like Armenia and Romania, the territorial fragmentation which creates large numbers of small units requiring full audit procedures, however small their budgets.

There is widespread legal provision for local governments to employ commercial auditors. This is occasionally utilized, mainly to obtain credit ratings for loans. Authors of these studies felt that commercial audit is more likely to be exercised in a positive style, as a way of promoting improved management rather than control for its own sake. However, commercial auditors are mainly trained to scrutinize private enterprise operations with a heavy emphasis on aspects such as the valuation of assets, and are generally

unfamiliar with the priorities of local government audit. The local government market for commercial auditors is not competitive with a growing private sector demand, and costs are prohibitive for smaller local budgets.

INTERNAL AUDIT

Legal Requirements

Local government units are required to establish internal audit units in Armenia, Croatia (in municipalities over 35,000 in population, running primary education or employing over 50 staff members), Macedonia (with populations of over 15,000), Romania (for budgets exceeding EUR 100,000), and Serbia. In Russia and Ukraine, internal control sections form part of vertical hierarchies subordinate to the Ministry of Finance.

Elsewhere, Ministry of Finance regulations mandating internal audit are currently in draft in Moldova. In Bosnia and Herzegovina and Montenegro, some municipalities have established internal audit sections voluntarily.

In Albania, Croatia, Macedonia, Romania, and Serbia Ministries of Finance have established central harmonization units to integrate the procedures and standards of internal audit throughout the public sector, and organize associated training.

The Practice

As in the case of external audit, the practice in several cases falls short of the legal requirement. For example:

- By 2006, only 35 percent of Romanian authorities obliged to establish internal audit units had done so, and 85 percent of these had appointed only one member of staff to them.
- In *Serbia*, few municipalities (mainly in Belgrade and Vojvodina) have as yet formed internal audit units.
- In *Macedonia*, 20 units have so far been set up out of 42 mandated.
- In *Armenia* 34 out of 41 urban municipalities have established units, though very few are in rural areas.

Buying in part-time services is one solution for small authorities. In Croatia, most small municipalities buy in the county internal audit service. In Romania some local authorities contract internal audit to outsiders, such as economics teachers.

Provision in countries like Macedonia for smaller municipalities to establish joint internal audit units, or to buy in the services of larger towns, have been largely ignored. There is reluctance to share access to their books with their neighbors.

Shortfalls in provision have been ascribed variously to the cost or non-availability of qualified staff, as well as to the apathy of elected members or executives.

SCOPE OF AUDIT

In all countries surveyed, the audit that actually takes place, is primarily concerned with issues of *regularity*, i.e., of the compliance of financial transactions with laws and official procedures, and of the conformity of revenues and expenditures to budgets, and budget variations approved by legislative bodies.

In the Balkan countries, in Georgia and, to some extent Ukraine, audit is also expected or, at least authorized, to examine the utilization of local budgets in terms of *performance* and *efficiency*. The country reports suggest that this mandate is largely ignored in practice. Audit staff and time are preoccupied with verifying regularity. Staff lack skills in scrutinizing performance and efficiency, and there is little experience or demand for them to do so.

Russia has recently introduced performance budgeting and reporting at all levels of government. This has effectively created a market for professional advice on the construction of performance-measurement databases and analytical skills.

ACCESS TO AUDIT REPORTS

Reports by state audit institutions are normally submitted to individual parliaments. In most cases, however, copies are sent to the councils under scrutiny, or are available on websites.

The prime audience for *external* audit findings should be the elected council which approves the budget under scrutiny. It is less likely to pay attention to reports which are not specifically addressed to it, or where comments are lost in generalities applied to several or all local governments.

Ideally, civil society should also have access to them since councils and their executives may well collude in mismanagement of public money. In practice, public access to external audit reports is more restricted in several of the countries surveyed. In Armenia, audit reports can only be accessed by application under the Freedom of Information Law. In Azerbaijan, a list of audits undertaken is published on a website, though the results are not disclosed. In Russia and Ukraine, reports on budget execution are submitted to local councils, though they receive no publicity. There is no public access to reports in Moldova.

Internal audit reports are almost invariably confidential and submitted to the chief executive, except where specifically prepared for a finance commission, as in Georgia.

In general, public access to audit findings is increasing with the use of web-site publication and freedom-of-information legislation. The cautious and opaque language used does demand a familiarity and an ability to “read between the lines” which discourages public interest in these reports, and their ability to gauge their significance. Reference has been made in discussion to a Bulgarian donor-aided project which enhanced the ability of audit agencies to produce public-friendly versions of their reports, and of media and civil society organizations to understand their meaning. This could provide a model for LGI intervention on a wider regional stage.

HUMAN RESOURCES

Most of the individual country studies describe a formalized structure of training and qualifications surrounding the staffing and operation of external audit institutions, whether state or private. They increasingly include membership of INTOSAI and adherence to IFAC standards. An exception is Georgia, where accreditation requirements for private auditors were jettisoned in a general campaign for deregulation.

The state bodies vary, however, in the adequacy of trained staffing numbers. The Romanian county branches are 50 percent below establishment, while the Serbian State Audit Institution still awaits practical formation. The problems relate principally to recruitment, since the required accounting skills are generally better rewarded in the private sector.

Internal audit presents a greater challenge. Only larger and more urbanized local governments can attract and afford graduate professionals. In Russia, the smaller and more rural municipalities cannot even afford to send staff to the training courses that are available to them. In countries like Croatia, Macedonia, and Romania, pre-accession reforms have inspired the creation of central units in the ministries of finance charged with “harmonizing” standards of internal audit across the public sector as a whole. These are promoting capacity within local governments, though the problems of affordability and career prospects remain.

A general problem is lack of training and experience in the practice of performance, “value for money” audit. Another possible LGI intervention might be to help a regional institution to develop a “training of trainers” program in this field aimed at those responsible for teaching professional audit courses in individual countries. The development of sample performance indicators for local governments has also been suggested.

CONCLUSIONS

Relatively strong legal frameworks for local government audit are now in place in most of the countries studied, particularly those in some stage of preparation for EU membership. Implementation, however, has barely started in Serbia. Many local governments never see an auditor, some only rarely.

Adequate audit is expensive, taking the time of staff who need to be well qualified and well paid to stay in the public sector and work honestly and independently. Countries with fragmented local government systems find it particularly difficult to provide both external and internal audit to a large number of small, mainly rural local bodies; they may be spending little money, though the control procedures are the same for large and small. It could be argued that the absence of audit matters less in rural communities where “everyone knows what’s going on”; but the realities of village politics may also shelter officials from the consequences of their misconduct, however obvious. Persuading small municipalities to share internal audit services with neighbors, towns, or counties is one solution.

The conclusion of the Russian study is that much audit is carried out, but no one takes any notice of its findings. This may be because of a suspicion that the purpose of audit is to maintain vertical power and punish independent-minded mayors rather than protect the public.

Audit suffers from the legacies of the communist past when it was seen as an instrument of vertical intrusion, driven as much by inter-personal relations within the hierarchy as by concerns for integrity and efficiency. In a democratic society, effective audit is essential, and not inimical to local autonomy, because it plays a vital part in securing public trust.

Audit needs to gain *perceived value*. For this it needs to be regular, not an apparently random and punitive intervention. Its findings need to be accessible to elected members as well as to civil society, including the media. Finally, it needs to be concerned with more than misconduct or inaccuracy, giving positive help to the improvement of performance and efficiency.

Local Government Audit in Albania

Sabina Ymeri

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INTRODUCTION

The Albanian local government financial management and audit system is currently undergoing reform within a wider reform of public finance management. Decentralization reform has been quite successful and local governments have consolidated their management, public service delivery, and investment capacities. At this stage, as local governments manage a growing portion of public funds and as their role in the economy increases, efficient financial management and auditing functions are crucial.

According to the law on local governments,¹ local units are subject to financial control by the High State Audit, which is the supreme audit institution that audits all public entities and reports directly to Parliament. Furthermore, local governments are also subject to audit by the prefect (the highest central-government regional representative) with regard to the financial affairs of functions delegated by the central government. The management of public money is centralized through a unified treasury account, thus the treasury system is also an important tool for financial control of all public entities—or budget spenders—including local governments.

LEGISLATION

The budgetary system in Albania is composed of the state budget and the local budgets.² Local budgets are distinct from the state budget; however, transfers from the state budget to individual local governments constitute one of the main sources of financing for local budgets.

Parliament may be considered one of the major actors in the field of internal financial control in the Republic of Albania. Parliament not only adopts the overall legal framework governing financial management in the country, but it may also makes recommendations for improving the financial management of the budgetary system through its permanent Economy and Finance Commission. Furthermore, Parliament has the right to initiate *ad-hoc* investigative commissions on specific issues, including financial management issues. In early 2003, a parliamentary commission for the scrutiny of financial management affairs in the municipality of Tirana was established, following allegations of financial abuse of public funds by its mayor Edi Rama.³

The Council of Ministers also has the responsibility of public finance management, the drafting of financial and economic policies, and state budget execution. Such responsibilities are primarily carried out by the Ministry of Finance, which has been given the primary responsibility in public finance management and internal financial control through the organic budget law⁴ and the law on internal audit in the public sector.⁵ A new organic budget law that is currently being prepared is expected to bring major improvements in the financial management in the budgetary system, including

the reinforcement of the supervisory role of the Ministry of Finance and the introduction of performance budgeting concepts.

External audit in the public sector is carried out by the High State Audit, an independent body that reports directly to Parliament. The chairman of the High State Audit is appointed by Parliament, on a seven-year mandate, and its activity is regulated by a special law. The High State Audit has unlimited access to all public entities in the budgetary system, central and local government units, independent institutions, companies that are controlled by the public sector, and political parties to the extent by which they are financed by the state budget, etc. However, the High State Audit may only issue recommendations on measures to be taken by competent authorities based on the findings of audits it carried out; including suggestions for amendments in the legal framework. Its recommendations are not binding on public entities, but are, however, usually taken into consideration.

1. SCOPE OF STATE AUDIT OF LOCAL GOVERNMENT FINANCIAL AFFAIRS

The local government law states that each unit of local government shall be subject to external control by the High State Audit, which is based on the principle of the legality of the use of financial resources; and to external financial control by the organs of central government, in the manner as stipulated by law.⁶ The organic budget law and the law on internal audit in the public sector also establish the right of the Ministry of Finance to perform financial inspection and “internal financial control” of local government affairs.

1.1 High State Audit

The High State Audit (HSA) is in charge of conducting external financial control of local government units. HSA certifies the executed budget in the Republic of Albania, its area of control being the lawfulness of financial management, as well as control of the efficient and effective use of public funds. The High State Audit has unlimited access to all public entities in order to assess the legality of budgetary transactions, as well as has the right to supervise internal audit structures of public institutions and assess the overall internal audit systems and standards.

The High State Audit does not have specific obligations regarding the periodicity of external audit in public entities, or to audit predefined topics or fields. It operates through three regional offices, which are in charge of auditing all local government units. However, it usually audits bigger municipalities once every two years, whereas audit of

communes and smaller municipalities takes place rarely if ever. Given that there are 373 local government units in Albania, 308 of which are communes, it is understandable that the High State Audit does not have sufficient capacity in terms of staff to annually audit all local government units. Nevertheless, the HSA may also intervene with sporadic audits of smaller local governments at unexpected times; especially in cases when financial control activities from other government bodies (such as the prefect) indicate shortcomings in local government operations.

The scope of financial control by the High State Audit extends to control of the legality of local financial affairs, as well as “value for money assessments.” All controls conducted by this institution are *ex post* controls, following the closing of the budget year and extend to all financial sources of local governments, originating both from the state budget as well as from own sources. Anecdotal evidence shows that such controls are not very efficient. Auditors of the High State Audit usually limit their scope of scrutiny in issues of legality, rather than efficiency. Furthermore, audit specialists are reported as not being thoroughly knowledgeable about local financial affairs, and their findings have thus, at times, been challenged by local government officials.

1.2 Central Government Audit

As a considerable part of the financial resources available to local governments is provided by the central government, the central government has a legitimate right to conduct external financial control of local governments. In theory, and in compliance with the spirit of the local government law, such control should consist of the compliance with the legislation already in force, or the relevant agreements with the central government institutions with regard to the use of conditional intergovernmental transfers. Thus, central government scrutiny over local financial affairs should extend only to funds originating from the state budget. Practice, however, differs from the legislation currently in force.

Currently, the central government exercises control over local government units through the prefect, the unified treasury system, and through the General Audit Directorate of the Ministry of Finance. The procurement legislation also provides for the audit of all public procurements by a centrally established agency.

1.3 Prefects

By law, the scope of financial audit by the prefect⁷ is rather narrow and extends only to the control of the performance of delegated functions and responsibilities, as well as funds used for such purpose. However, the prefect audits all financial affairs of local

governments, extending his/her scrutiny not only to funds originating from the state budget for purposes of delegated functions, but to other state budget transfers and own resources of local governments—such as own taxes, fees, and other financial sources.

The prefect audits all local government units (municipalities and communes, as well as regional councils), including their subordinate institutions within his jurisdiction, typically annually. The prefect reports to the central government and his audits may be both generic as well as thematic—typically the prefect builds upon the reports of internal auditors of local governments, though he may initiate separate audit activities as well.

Financial audits of the prefect focus on the formal aspects of financial management—legality of financial transactions—but do not cover issues of efficiency. The prefect audit function does not differentiate between funds originating from the State Budget and own-source funds. This practice originates from 2003, when there was no adequate legal framework in place for internal auditing, and a Council of Ministers' decision assigned the function of financial control of local government units to the prefects,⁸ who had the responsibility of annually auditing all local government units. This was intended to be an intermediate measure to extend the function of financial control to all public entities, pending the adoption of a separate law on internal auditing in the public sector. By 2003, the law on internal audit in the public sector had been adopted by Parliament⁹ and the Council of Ministers' decision abrogated; however, the practice of prefects auditing local governments was not discontinued. The central government, through the prefect, continues to violate local autonomy, by unlawfully extending their scope of scrutiny to locally generated funds, as well as the state budget transfers for own functions.

1.4 Ministry of Finance—Treasury

Public money in the Republic of Albania is managed through a unified Treasury Account, and administered centrally by the Ministry of Finance. The Treasury is the main body responsible for *ex ante* financial control with regard to financial operations of both central and local government units. The Treasury has the authority to supervise the budget and verifies all payment orders against the relevant appropriations in the budget and availability of funds in the government unit account, alongside with the requirement of relevant original documentation to authorize the disbursement of public funds. The Treasury, thus, serves as a financial control mechanism for local governments. Treasury offices are set up at district level and are subordinate to the Ministry of Finance.

Management of local funds (in cash) is almost an exclusive authority of the unified Treasury Account. Treasury manages all financial resources of local governments, inter-governmental transfers (unconditional and conditional) as well as all locally generated revenues, taxes and fees, or other resources.

Local Governments submit their budgets as adopted by the local council to the Treasury, which in turn uses such documents to verify that expenditures are in accordance with the budget and all the necessary documentation (contracts, payment orders, authorizing officer signature, etc.) are in place. Treasury controls, however, are only confined to the formal aspect of budget execution and do not extend to the efficient use of public funds.

Every month local governments and the Treasury compile consolidated statements for actual revenues and expenditures. At the end of the year local governments and the Treasury compile an annual consolidated statement, which is then submitted to the Ministry of Finance.

1.5 Ministry of Finance—General Audit Directorate

The General Audit Directorate (GAD) of the Ministry of Finance was first established in 2000, following the reorganization and modernization of internal audit in the public sector, which was aimed at establishing internal audit units in all central government entities. Since then, the General Audit Directorate¹⁰ served as the central audit organization, in charge of supervising auditing functions of other institutions, as well as providing methodological guidance, issuing and upgrading auditing standards, the training and certification of internal public auditors, etc.

The internal audit function was first extended to local governments in 2003, providing for the establishment of internal audit units in all local governments, which are independent of all other operational units within the local government and report directly to the mayors. The legal framework on internal auditing in the government sector, including local governments, was further improved by the new Law No. 9720, dated April 23, 2007,¹¹ which represents a first attempt at introducing the principles of public financial internal control (PIFC), and defines the main actors of auditing in the public sector as following:

- The Minister of Finance, who coordinates the activity of internal auditing and bylaws;
- Internal Auditing Committee, an advisory body to the Minister of Finance;
- General Audit Directorate, as an organizational part of the Ministry of Finance;
- Internal auditing units, acting within the public audited entities (including local governments). The Council of Ministers approves the criteria for establishing internal auditing units and they report to the appointing body (the mayor) and to the General Audit Directorate.

The General Audit Directorate extends its scope of work to all the budgetary system in Albania, including independent institutions such as Parliament, the Office of the President, and other independent institutions regarding the service of internal auditing. Furthermore, it cooperates with the High State Audit regarding the exchange information, submission of annual auditing programs, and annual summarized reports, upon request from the parties.

The General Audit Directorate's scope of authority extends to local government units in the same fashion as with central government institutions. The auditing units of local governments have to submit annual auditing programs for approval to GAD and report to it as well. GAD itself may also initiate auditing missions within local governments in special cases, but only in cooperation with local auditing units. GAD may also directly audit local government units if they lack an own internal-auditing structure. Furthermore, the General Audit Directorate may supervise and monitor the activity of internal audit structures.

Secondary legislation for the law on internal auditing in the public sector is not in place yet, and it is still too early to comment on its efficiency regarding local governments. This legal initiative was highly controversial in itself and gave rise to lively discussions among policymakers and during parliamentary discussions, as it was interpreted as an attempt to extend oversight of the Ministry of Finance (and therefore exercise pressure) on independent institutions and local government units. The High State Audit and other stakeholders also expressed concern that the role envisaged for the General Audit Directorate overlaps with the mission of HSA and interferes in its scope of work.

With regard to local governments, there are also specific concerns that the right of the General Audit Directorate to exercise "internal audit" in local government units may be in violation of local autonomy. Based on the organic local government law, financial control by the central government may be exercised only with regard to state budget transfers.¹² Furthermore, the mission of the General Audit Directorate also seems to overlap with the prefect's auditing function of local governments: there is no clear division of roles and responsibilities between the Prefect and the Ministry of Finance regarding local governments.

According to local governments, the General Audit Directorate is expected to completely take over the audit function from the prefects.¹³ The situation is still unclear, pending the adoption of the new organic budget law and the secondary legislation of the internal auditing law. However, it is uncertain whether the General Audit Directorate will have enough capacity in terms of staff and territorial outreach to exercise oversight over all 373 local governments.

1.6 Public Procurement Agency

The new law on public procurement,¹⁴ which became effective from the first of the year in 2007, established a modernized system of procurement by all public entities, which is based on the primary principle of transparency. The public procurement system is managed by the Agency of Public Procurement, a central institution that reports to the Council of Ministers. All contracting authorities (including local government units) are obliged to publish all documentation related to procurement activities on the official website of the Public Procurement Agency, including supporting information for interested parties.

Local government units, as contracting authorities in public procurement procedures, have the obligation to submit monitoring reports to the Public Procurement Agency every four months, as well as provide all necessary documentation to the Agency upon its request. The PPA monitors such reports by local government units (and all other public entities), and has the right to verify and inspect compliance with procurement procedures. The PPA thus acts as an auditing institution in the field of public procurement and has unlimited access to all documentation of central and local government units in relation to procurement procedures.

The Public Procurement Agency is the supreme institution of public procurement in the country and also acts as an organ of administrative appeal. The PPA may conduct administrative investigations in local government units, may suspend procurement procedures, and may recommend sanctions against public officials, should the need arise.

Besides the Public Procurement Agency, the new legal framework on public procurement also established the institution of the Procurement Ombudsman, who has the responsibility to monitor the overall system and public procurement procedures. The Procurement Ombudsman reports to Parliament at least once a year.

2. SCOPE OF LOCAL GOVERNMENT AUDITING

Local governments are required to establish internal audit structures, which have the responsibility to audit the local government administration, and must organize and exercise firm financial control over the activities of the spending agencies under their jurisdiction. Furthermore, according to the local government law,¹⁵ internal financial control should be exercised by the relevant administrative bodies of the municipality/commune, as well as by the councils of local governments: *“each local government council shall establish a financial commission, which shall act during the council mandate.”* The main function of the financial commission is to control the revenues and expenditures made by the executive body, in compliance with the budget adopted by the local council.

2.1 Internal Audit within Local Governments¹⁶

The internal auditor is appointed by the mayor and reports directly to him/her. A work schedule for the internal auditor is decided upon and approved by the mayor at the beginning of each year. Internal auditors may also conduct thematic auditing activities, or specific audits based on the mayor's or the council's request. Internal auditing takes place at least annually in the municipal administration and their subordinate institutions, including municipal companies.

All local governments are required by law to have an internal auditor. The role that the auditor plays in the financial management of the municipality is to serve as the mayor's check on the financial compliance of the municipality and all sub-institutions according to the law governing their activities. The auditor also makes recommendations for improvement and prepares reports for the mayor.

This internal control is focused on the legal aspects of financial management, accounting procedures, and on checking calculations. The internal audit checks that the accounting is done in the correct manner. For own functions, it also ensures that the spending is in line with the budget. For delegated functions, it controls that amounts correspond to line ministry instructions.

Internal auditing continues to be performed in the traditional way. Despite new legislation that provides for internal auditing as, "*an independent activity that assures and advises the management and managing activities on the effective use of funds ... and assesses risk, performance, control, and management systems*" internal auditors focus exclusively on legal and accounting aspects and do not assess if resources are used efficiently. The internal audit does not check that the money accounted for is actually spent accordingly. This is the exclusive role of the supervisors and directors within the different departments.

Internal auditors prepare reports on their auditing activities that are then presented to the mayor. If legal transgressions are found, the cases are handed over to the court. Otherwise, the mayor has the responsibility to decide on any follow-up actions, which might include penalties or improvements to be implemented, amongst others. Internal auditors also follow up on the recommendations of the High State Audit and the prefects.

Internal auditors report to the mayor. Usually the mayor reports to the council in their periodic meetings. Otherwise, the council also has the right to request that internal auditors report directly to them, but this does not occur frequently. The council, however, does not have independent access to the reports of the Internal Auditor, or to any other reports on the performance of the administration.

The Finance Commission of the local government council (which is not part of the Internal Audit office or the local administration) may conduct occasional internal control audits. For exercising its functions, the commission requires the local government administration to report regularly in the course of the year and submit documents it

requests at any time. In addition to the review of the reports and documents submitted, the financial commission should control all accounting and financial documents.

2.2 External Independent Auditing

There is no legal requirement for the independent external auditing of local governments. The local council has the authority to request an external audit of the accounts, to be conducted by a certified external auditor. To date, no local government is reported to have contracted independent auditing by a certified auditing company. Independent auditing services are not affordable for the majority of local governments, with the exception of a few larger municipalities.

It can be expected that following the adoption by Parliament of the law on borrowing by local governments, bigger local governments may be interested in having their accounts checked and audited by a certified auditor. This would be a market-driven shift towards more reliable, truly independent financial audits. It is worth noting, however, that independent auditing companies in Albania are not very familiar with the public sector. Therefore—should there be demand in the future by local governments for independent external auditing—this will require the diversification of audit companies' know-how and expertise in the public sector as well.

2.3 Municipal Companies

Municipal companies are subject to the legislation on commercial companies and therefore also subject to auditing regulations as per all commercial companies. However, the majority of municipal companies are controlled by the local governments themselves. In the instances when the local government (public sector) owns more than 50 percent of the total shares of the company, the latter is subject to auditing practices in the same fashion as other governmental institutions, such as local governments.

Municipal companies report directly to the local government, typically the mayor (although the council is considered to be the shareholder). Such companies are expected to comprehensively report on all financial transactions, especially municipal subsidies, or revenues raised from fees of the local government. The majority of municipal companies are heavily dependent on municipal subsidies and their budgets are consolidated within the local budget. Reporting occurs during local government budget preparation or local government reports on execution of the previous year's budget.

Municipal companies are thus subject to audit by the State Audit (during the auditing of the local governments); by the prefect; by the Ministry of Finance; as well as the internal auditing structures of local governments.

3. TRANSPARENCY AND ACCOUNTABILITY

The legal framework on internal auditing in the public sector emphasizes the need for the establishment of internal audit structures that are separate from all other activities of the organization and do not have other operational responsibilities therein. Internal auditing structures should report directly to the Superior of the Institution—this being the mayor in the case of local governments. Furthermore, the General Auditing Directorate at the Ministry of Finance has professional authority over all internal auditing structures and provides methodological guidance and support to internal audits.

Such independence and objectivity has been achieved in larger local governments, whereas in smaller ones the internal audit function is assigned to staff members who also have other responsibilities, such as finance officers. This creates confusion in some local governments, and the functions of financial control and financial audit at times overlap with each other.

Internal auditors are accountable to the mayor (and to a certain extent to the General Audit Directorate). They are not accountable to the council, and the latter is typically informed of the results of auditing activities by the mayor. There is no special legal requirement that internal audit reports be made public. Such reports are usually presented to the mayor when carried out by internal audit structures of the local government; and to the mayor and relevant line Ministry when carried out by the prefect. Audit reports are also made available to the General Audit Directorate. The actual power of the elected councils in their monitoring and control function is weak.

The High State Audit reports annually to Parliament on its auditing activity and publishes a periodic bulletin. The HSA has an active official website where it publishes all relevant information, including periodic and annual activity reports. Furthermore, the findings of the High State Audit are largely reported through the media. However, media reports are limited to a mere citation of figures from HSA reports, and may often be misleading to the public.

Transparency is one of the weakest links of the financial-management system throughout the country, starting from budget preparations to financial control and auditing activities. The information flow on budget execution and auditing is limited within local government organizations themselves, between the administrative staff and the local councils. A few initiatives from civil society organizations regarding the monitoring of government financial affairs have focused primarily on budgeting activities, aiming at encouraging participatory budgeting techniques in order to enable fund allocation based on citizen needs and priorities. However, as civil society (especially at the local level) has not been able to develop a watchdog role in government affairs, any activities in this field are still lacking.

4. HUMAN RESOURCE DEVELOPMENT

Internal auditors in the public sector need to possess a series of qualifications, as mandated by the law on internal auditing in the public sector. Internal auditors are civil servants, and they must also possess a university degree in economics or any related fields: law, or other disciplines deemed necessary by the General Audit Director for the auditable sector. Furthermore, internal auditors must have at least three years of experience in auditing or related disciplines. By the end of 2009 (two years following the current law's coming into effect), internal auditors must have received certification as "Internal Auditor in the Public Sector," which is issued by a special Qualification Committee.

Internal auditors are obliged to constantly participate in trainings and other professional upgrading programs, as managed and scheduled by the General Audit Directorate. Indeed, one of the most important responsibilities of the directorate is the preparation of methodological manuals, the upgrading of standard, and providing information and training activities for internal auditors in the public sector. New national accounting standards, compatible with international standards, have become effective as of January 1, 2008. This will certainly require intensive training and awareness campaigns for internal auditors.

Aside from compulsory training managed by the General Audit Directorate, various donor programs provide training for internal auditors in the public sector. However, such trainings are sporadic and typically not well coordinated with the target institution's needs and capacities.

The High State Audit is a member of INTOSAI and of EUROSAI and has cooperation with various other professional international organizations. Furthermore, several donor programs have supported the establishment of an appropriate legal and institutional framework for public finance management, financial control, and internal audit in the Republic of Albania, such as a CARDS 2001 project to introduce a sound and modern system of audit in the public sector in Albania;. Furthermore, projects to encourage sound financial management are in progress under the auspices of the World Bank, the US Agency for International Development, among others.

5. CONCLUSIONS

Efficient financial control and auditing functions are indispensable to ensure that governance objectives are met, and may also be powerful tools to enhance efficiency and effectiveness in the use of resources. The current system of local government audit has some clear shortcomings. The most important issue that needs to be resolved is the lack of clarity in the division of roles and responsibilities. The distinction between internal auditing (within the local government) and external auditing is unclear, as some of the

audits performed by central government institutions are also regarded as internal audits. Furthermore, the audit function of the prefect and the Ministry of Finance overlap; there is no clear division of responsibilities, which undermines accountability.

The role of local councils in monitoring the financial affairs of the local government is weak; they do not have direct access to audit reports. The role of the council and its finance commission should be strengthened; they should have direct access to reports and be able to propose measures based on the findings of such reports.

Traditionally, auditing focuses on legality rather than efficiency. In the majority of local governments it still focuses on financial compliance and accounting rules, ignoring the need for recommendations to management or value-for-money assessments. However, such modern concepts are increasingly being introduced and accepted in the public sector, which is gradually moving on to performance budgeting and therefore more efficient auditing practices.

METHODOLOGY

This report was prepared within the framework of the Audit Function Survey of OSI/LGI in December 2007–January 2008. The preparation of this report relied extensively on secondary research, namely a review of the financial and auditing legislative framework, as well as existing studies and reports on financial management and auditing issues at the local level. The report also built on previous research carried out by the Institute for Contemporary Studies on the issue.

Secondary research was complemented by findings from interviews of officials at different government levels, from the Ministry of Finance, the General Auditing Directorate of the Ministry of Finance, Association of Municipalities, as well as officials from several local governments (Berat, Fier, Lac, and Tirana municipalities).

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NOTES

¹ Law No. 8652 on the Organization and Functioning of Local Government Units, dated July 31, 2000; hereinafter the Local Government Law.

² Constitution of the Republic of Albania, Article 157.

³ The Parliamentary Commission was initiated based on the request of the opposition, to investigate financial affairs of the Municipality of Tirana and the Ministry of Culture, based on allegations of misappropriation of public funds when these two institutions were led by prominent SP figure Rama. Analysts considered the parliamentary commission, which did not result in any clear findings, as an attempt to influence the outcome of local elections that took place in late 2003.

⁴ Law No. 8379 on the Drafting and Execution of Budget in the Republic of Albania, dated July 29, 1998.

⁵ Law No. 9720 on Internal Audit in the Public Sector, dated April 23, 2007.

⁶ Law No. 8652, Article 22.

⁷ Law No. 8927 on Prefects, Article 16, dated July 25, 2001.

⁸ Council of Ministers Decision No. 217 on Financial Control, dated May 5, 2000, abrogated in 2003.

⁹ Law No. 9009, of 2003, later abrogated by Law No. 9720 on Internal Auditing in the Public Sector, dated April 3, 2007.

- ¹⁰ Formerly General Directorate of Public Internal Financial Control.
- ¹¹ Still acting with old by-laws, pending the approval of the new Organic Budget Law.
- ¹² Indeed, it is believed that central government audit should only extend to conditional transfers for delegated functions, which are originally functions of the central government and are performed at the local level. As regards state budget transfers for own (exclusive) functions of local governments, the financial control takes place during the appropriation in the budget, such as the formula of allocation of the unconditional transfer, or conditions and criteria for the allocation of conditional transfers.
- ¹³ As previously mentioned, secondary legislation has not yet been approved, and GAD officials are reported to have maintained this perspective in disseminating meetings with local governments and other stakeholders.
- ¹⁴ Law No. 9643 on Public Procurement, dated November 20, 2006.
- ¹⁵ Law No. 8652, Article 21.
- ¹⁶ Note that internal control/audit is defined as all the audit procedures performed by institutions within the central and local governments. This means that, in addition to the internal audits performed by local government own audit structures, audits by the Ministry of Finance are also considered internal audits.

Audit in the Local Self-government System of the Republic of Armenia: Legislative Frameworks and Practices

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INTRODUCTION

This study aims to examine the existing situation and find out the problems of audit within the local self-government system of the Republic of Armenia. To this end, a survey has been taken in urban, rural, and district municipalities throughout Armenia.

For an audit to be meaningful, municipalities must possess financial capacities. The majority of Armenia's 866 rural municipalities are financially weak. Because of this, all its urban (48) and district (12) municipalities, as well as one rural municipality from each *marz* (region) (ten rural municipalities in total) were included in the sampling (70 municipalities in total). Rural municipalities were selected based on the revenues of the municipalities' administrative budget (the municipalities were selected where that index on January 1, 2006 had its maximum value).

In seven out of the 48 urban municipalities the survey was not implemented because of technical difficulties, particularly the absence of means of communication.

1. AUDIT IN THE LOCAL SELF-GOVERNMENT SYSTEM OF THE REPUBLIC OF ARMENIA

1.1 Local Self-government and Its Control

The public government system in the Republic of Armenia has a two-tier structure: central (state) government and local self-government.¹

Local self-government is a separate tier of government. The bodies of local self-government consist of the municipal head and council. These are each elected for a four-year term through direct, general, and equal elections. The council is a representative authority. The head of the municipality is the executive body of local self-government. He/she implements the decisions of the municipality council through their staff and municipal organizations.

Local self-government bodies execute state authorities and responsibilities, which are granted to them by law. Local self-government bodies' authorities consist of own and delegated authorities. Authorities delegated by the state are funded by the state budget. Own authorities are funded by the local budget. Own responsibilities are divided into mandatory and voluntary powers.

In Armenia, local self-government is implemented in urban, rural, and district municipalities throughout Armenia. Each urban or rural municipality may consist of one or more settlements. There are 1,000 settlements in Armenia, but only 926

municipalities.² The latter consists of 48 urban municipalities, 866 rural municipalities, and 12 Yerevan district municipalities.

The territory of Armenia is divided into 11 *marz*. The *marz* is both an administrative and territorial unit. It is not a separate tier of the government. The government bodies of *marzes*, i.e., *marzpet* and *marzpetaran*, are governmental subdivisions.

Currently, Yerevan has the status of *marz*. Yerevan was recognized as a municipality after the adoption of amendments to the Constitution (November 27, 2005). According to the transitional provisions of the Constitution, local self-government bodies in Yerevan are to be formed no later than two years after the adoption of the relevant law. This means that local self-government bodies in Yerevan should be formed by autumn of 2009.

According to D. Tumanyan, the municipality (community) may be represented in both the broad and narrow senses of the word.

In the broad sense, the municipality is an administrative/territorial unit as well as a group of residents, within the boundaries of which the residents implement local self-government directly or through elected bodies.

In the narrow sense, the municipality is a legal entity. The municipality has its government bodies and property (which the municipality manages independently); it may receive and implement interests, bear responsibilities, and act as a plaintiff or defendant in court.

The effectiveness of each organization's activity greatly depends on its management.³ Management is the organization's goal, achieved through various tools. These tools are used to influence the organization's material, human, financial, and other resources. In management theory, these tools are known as "management functions." These functions are as follows: planning, organizing, managing, and control.

Control is defined here as a set of activities and procedures used to ensure the performance of programs, the use of resources for defined objectives, outputs, goals, the protection of programs from mistakes and failures, and the receipt of timely and accurate information needed for decision-making. Without these procedures the effectiveness of management is compromised.

Control assumes the following:

- Appraisal of municipalities' and municipal organizations' activities according to the requirements of the legislation of Armenia regulating those activities;
- Appraisal (in terms of authenticity and correctness) of financial statements provided by municipalities and municipal organizations;
- Revision of variances in accounting records of municipalities and municipal organizations;
- Revision of artificial obstacles preventing municipalities and municipal organizations to act.

- Revision of illegal activities of municipalities and municipal organizations;
- Appraisal of expenditure savings and use of saving possibilities provided by municipalities and municipal organizations;
- Maintaining budget planning and executing it in due course;
- Summarization and appraisal of planned objectives' implementation;
- Clarifications of deviations from plans and correction of the deviations;
- Summarization of budget execution results and comparison with planned results, etc.

There are both *internal* and *external controls* of the municipalities' activities.⁴

The main bodies of internal control over municipal activities are the head and council of the municipality. The council should form a commission from among its members to perform effective control. It can also engage the services of an *external auditor*.

Permanent and general control over the municipality's activities is exercised by the municipal head, together with heads of the municipality's units and *internal audit* unit.

External control is exercised by central government bodies, authorized by law to exercise such control.

1.2 Internal Audit

According to Armenian legislation, the performance of internal audit is compulsory. Article 69 of the Law on Local Self-government of the Republic of Armenia states that the supervisory auditing service, which is part of the municipal staff, has to submit to the municipal council results and suggestions coming from its review of the annual statement on the budget's execution. This means that the audit service must exist within the municipalities.

The legal framework for the introduction of an internal audit in municipalities and municipal organizations are stated by the Law on the Treasury System of the Republic of Armenia. According to that law, the chief financial officers of the central and local governments have to ensure:

- The existence of financial flow management and internal control systems;
- The existence of the internal audit service in a manner prescribed by the authorized body (the Ministry of Finance and Economy).

For the purposes of implementation of this law, Decree No. 934 of the Minister of Finance and Economy was adopted. This decree clarifies the procedures of the internal

audit performance in the central and local governments as well as organizations that are under the central and local governments' supervision.

This decree defines the aims of the internal audit in the local and central governments, audit implementation bodies and frames and its frequency, amongst other things. According to the above-mentioned decree, the internal audit is performed by the chief auditor, who acts under the direct supervision of the chief financial officer. If financial inconsistencies arise, an audit committee can be created at the decision of the municipal head. This committee is managed by the chief auditor.

The Ministry of Finance and Economy coordinates and controls all the internal audit procedures carried out by the both central and local governments. The Ministry of Finance and Economy implements the following:

- a) Receives and reviews annual auditing plans and gives his approval;
- b) Receives and reviews audit reports;
- c) Submits to the chief financial officer the *mandatory* execution guidance.

According to Article 19 of the Law on Legal Acts, norms for the legal entities on execution of their obligations, as well as norms for control or audit in those entities, cannot be established by ministerial decrees. Legal acts (decrees) of this sort, or their appropriate entities, do not have legislative power.

An internal audit was performed in 34 out of 41 participating urban municipalities in 2007.⁵ In reviewing the three-year tendency (2005–2007) an increase in this number is seen.

Reasons for not performing the internal audit in urban municipalities vary. In two municipalities where the internal audit was not performed, the internal audit was perceived as meaningless. There was a distorted understanding of the internal audit in one municipality. One participating municipality was unaware that the audit was mandatory. In the remaining municipalities where the internal audit was not performed, the absence of internal audit was explained by a lack of capacity.

A few of the 41 urban municipalities participating in the survey (only 17 percent) believed the internal audit to be a fictitious procedure. The remaining 34 municipalities understood the importance of the internal audit.

The situation is different as regards rural municipalities. Three out of the ten surveyed rural municipalities performed an internal audit in 2007. This data has remained unchanged since 2005. In these three municipalities, the fact that legislation stipulates the mandatory nature of the internal audit is unknown. But most rural municipalities do understand the importance of the internal audit. Three out of seven rural municipalities where the internal audit was not performed responded that their reasons for foregoing the internal audit were “unknown.” The remaining four municipalities responded that they lack the financial means to employ the appropriate professionals.

Regarding district municipalities, there was only one municipality where the internal audit was not performed, reasoning that the internal audit is meaningless because an external audit is already performed in the municipalities.

The survey shows that the performance of the internal audit, when there were no impediments (for instance, lack of human resources) to its execution, is ongoing.

1.3 External Audit

There are two laws pertaining to the external audit: the Law on Local Self-government and the Law on Budgetary Systems. According to Articles 68 and 69 of the Law on Local Self-government, in order to constantly and effectively realize the control of budget performance, the municipal council can contract an independent auditing service. According to Article 35 of the Law on Budgetary Systems, the annual statement of budget performance in the council session should be discussed and approved in light of a professional auditing organization's conclusion.

According to the Law on Budgetary Systems, performance of the external audit in the municipalities is compulsory, though according to the Law on Local Self-government, it is not. The existing contradictions between the laws are regulated by the Law on Legal Acts. Accordingly, there must not be contradictions in legal acts that have equal legal power and are adopted by the same body. In the case of a contradiction between legal acts having the same legal power, the norms of initial legal act are put into effect. The Law on Budgetary Systems was put into effect earlier than the Law on Local Self-government.

Very few urban municipalities that participated in the survey invited an external auditor. Nine urban municipalities invited an external auditing service in 2005 and 2006, and eight urban municipalities were planning to invite them in 2007. In general, during these three years, 28 urban municipalities have not performed an external audit (68 percent of urban municipalities participated in the survey). The majority of the municipalities (18) state that the main reason for not performing an external audit is the lack of financial means. Among these reasons are the absence of an auditing service in the area, the high price of the service, and the legal efficiency of the external audit.

It should be mentioned that only four municipalities consider the external audit to be a formality. The rest of the municipalities find the role of the external audit very important in their municipality.

As for rural municipalities, only one municipality out of the ten that participated in the survey invited an external auditing service. In none of the remaining participating rural municipalities was an external audit performed. Four rural municipalities state that the main reason for not performing the external audit was the lack of financial means. In three municipalities, it was difficult for them to answer. Municipalities cited various reasons for not performing the external audit such as the absence of an

auditing service in the area, the high price of the service, and the low efficiency of the external audit.

The number of the municipalities performing an external audit is larger within district municipalities. Ten district municipalities in 2005 and seven municipalities in 2006 invited external auditing services. Eight municipalities were planning to invite an external auditing service in 2007. The district municipalities also state that the main reason for not performing the external audit was a lack of financial means.

Most of the district municipalities (83 percent of district municipalities) find the external audit to be important.

In general, in participating municipalities, the external audit is not performed periodically. Regarding the years mentioned above, every year the external audit was performed in six urban, one rural, and seven district municipalities.

As the survey shows, the majority of both urban and rural municipalities point to the lack of financial means as reason for the absence of the external audit. Stemming from the above-mentioned circumstances, some attempts have been made to discover how the expenditure burden of an external audit really affects the municipal budget. In the municipalities, the average market price of “external audit” services varies greatly depending on different factors, such as the volume of planned work, the existence of auditing services in the area (in case of its absence, the administrative expenditures, for instance, transport expenditures, *per diem* expenses, etc., sharply increase), and the reputation of the firm performing audit, etc.

In order to define the average price of the “external audit” service, the actual expenses of the external audit in 2005 and 2006, and those anticipated one in 2007, have been measured in the survey. The result is as follows: in urban municipalities, the index is from AMD 150,000 to AMD 2,980,000, whereas in district municipalities it ranges from AMD 200,000 to AMD 4,500,000. The average price of the mentioned index in urban municipalities is AMD 588 whereas in district municipalities it is AMD 1,239,000.

It is impossible to calculate an average price in rural municipalities, as an external audit was performed in only one for the price of AMD 150,000.

In order to get more vivid indices, the expenditures of audit performance were compared with municipality budgetary revenues, as well as with administrative budget revenues (as the expenses of audit performance are financed from the administrative budget). On average, in urban municipalities, the specific amount of audit performance expenses, when compared to municipalities’ budget revenues, is 0.22 percent, and with respect to the municipalities’ administrative budget revenues it is 0.35 percent. The mentioned indices have lower values in district municipalities. Accordingly, they are 0.2 percent and 0.11 percent. According to the data of the only rural municipality to have performed an external audit, the specific amount of audit performance expenses with respect to the municipal budget revenues is 0.63 percent.

1.4 State Audit

State audit in the municipalities is performed by the *central government*. According to Article 34 of the Law on Budgetary Systems, the government audits (a financial audit) the use of targeted state-budget allocations to the municipalities' budgets (including subventions, allocations to the municipalities' budgets from the privatization of state-owned assets in accordance with law, as well as state financing of functions delegated to local governments), in addition to auditing the use and repayment schedule of loans from the state budget and other sources permitted by law through a state body authorized for such purpose by the government.

The results of the survey show that the Ministry of Finance and Economy usually extends the scope of audit. Except for the targeted state budget allocations, it also includes the use of own revenues of the municipal budget, especially those of the capital budget, the results of the internal audit, etc.

In 2005 and 2006, the Ministry of Finance and Economy performed audits in 19 and 27 urban municipalities, respectively. From this list, in 15 and 24 municipalities the scope of the state audit were extended. The same picture is drawn for the rural and district municipalities. In 2005 and 2006, the ministry audited two and five rural municipalities as well as four and ten district municipalities. In all the mentioned municipalities, the ministry extended the scope of the audits.

The dynamics of the audit performed by the ministry shows that not all the municipalities perform occasional audits. Regarding the above-mentioned years (2005 and 2006), the ministry performed audits in 14 urban, two rural, and three district municipalities each year. One urban, two rural, and zero district municipalities were audited by the Ministry of Finance and Economy in 2007.

Chamber of Control

According to Article 77 of the Law on Local Self-government, the National Assembly, as an entity known as the Chamber of Control, audits the purported use of state budget allocations no more than once a year. The state budget allocations to the municipalities are as follows:

- The amounts transferred from the state budget to the municipal budget for the purpose of covering the expenditures of the delegated powers;
- Subsidies transferred to the municipal budget according to the principles of financial equalization;
- Other subsidies from the state budget;
- Targeted state budget allocations for purposes to cover recurrent and capital expenditures (recurrent and capital subventions);

- Borrowings from the state to cover the deficits accrued during specific parts of the fiscal year;
- Loans (i.e., credits) from the state budget;
- Thirty percent of the revenues from the privatization of the state property and state held stocks of the legal entities located in the administrative territory of the municipality.⁶

In fact, the municipalities receive both targeted and unconditional grants from the state budget. Thus, it is practically impossible to separate the expenditures that are covered by unconditional grants from those covered with own revenues. As a result, the Chamber of Control is indirectly entitled to audit the municipal budget in its entirety.

According to the constitutional amendments of November 27, 2005, the Chamber of Control has been recognized as an independent body. The Chamber of Control controls budget funds, as well as use of state and municipal ownership. Procedures of activities and competence of the chamber are prescribed by law.

According to Article 5 of the Law on Chamber of Control, the chamber has the right to implement the following activities at the local level:

- Audit the expenditures of the municipal budget, as well as the legality and effectiveness of activities of the bodies responsible for inflows of the municipal budget;
- Audit the management and use of municipal property (including intellectual property and cultural values), including:
 - Implementation of municipal property's alienation, use and privatization plans;
 - Insolvency procedures of municipal institutions and organizations;
 - Legality and effectiveness of use of municipally-owned land, privatization, development, granting of land without indemnity (temporary or permanent), and land rental;
 - Legality and effective use of forests and water sources;
 - Own consumption (consumption for its needs) and inventory accounting of the municipal property prescribed to the municipalities or municipal non-commercial organizations.

According to Article 32 of the same law, the Chamber of Control is the assignee of the Chamber of Control of the National Assembly.

In 2005 and 2006, the Chamber of Control of the National Assembly performed audits in 13 and 15 urban, three and five rural, three and four district municipalities

accordingly. Up until the middle of June 2007, the chamber had performed audits in three urban, two rural, and two district municipalities.

According to the Law on the Chamber of Control, the chamber acts in accordance with the annual plan approved by the National Assembly. The chamber's 2005 and 2006 plans include a sample study in Armenia's regions as well as the municipalities that make up the city of Yerevan. Since the list of the municipalities where the study would take place was not clarified, the deviations of the chamber's activities from the approved plans has not been measured. In the 2007 plan, the list of municipalities where the study would take place was clarified. Although the survey results were expected by June 15, 2007, deviations from the plan are already noticeable. The annual report of the chamber (which includes the current reports of all the issues of the annual plan) should be presented and discussed in the National Assembly.

Marzpetarans (Regional Offices) and the City Hall of Yerevan

According to Article 77.2 of the Law on Local Self-government of the Republic of Armenia, the *marzpet* (the governor, though in Yerevan this means the mayor) controls the execution of the own powers in terms of legality⁷ and execution of the delegated powers in terms of professionalism.⁸

The *marzpet* exerts legal and professional control according to the annual plan established by the highest legal supervisory body (the Ministry of Territorial Administration).

In particular cases, where the *marzpet* has entered into a written agreement with the Ministry of Territorial Administration, it can also implement activities not included in the annual plan.

The control executed by the *marzpetaran* neither covers all the municipalities nor has a periodic nature. Of the urban municipalities controlled by the *marzpetaran* (regional office) and that participated in the survey, there were 12 in 2005, 15 in 2006, and nine as of June 15, 2007. From the rural municipalities that participated in the survey, three, two, and two were not controlled by the regional office. The Yerevan City Hall controlled two, three, and two district municipalities, respectively.

Ministries

The highest body of professional supervision for each delegated power is their respective ministry.

Professional control in the municipalities can be performed by the highest bodies of control in special cases, either with a written order from the Ministry of Territorial Administration or by the request of the *marzpet*.

The control of municipalities' legal acts is performed by the Ministry of Justice.

The Ministry of Territorial Administration performs legal control in municipalities where the municipal budget doesn't have a deficit.

In instances where the municipal budget is planned with a deficit, the head of the municipality, in cooperation with the Ministry of Territorial Administration and based on its rules, creates a plan for repayment of loans used for covering this deficit. During the implementation period, this plan is the basis of budget preparation. In this case, aside from legal control, the Ministry of Territorial Administration continuously exercises control of the plan's realization.

The *marzpet*, the Ministry of Territorial Administration, and the highest bodies of control, at the request of local government, must provide advice on both their own and the delegated powers' implementation.

Office of Public Prosecutor

According to Article 27 of the Law on the Office of Public Prosecutor of the Republic of Armenia, the prosecutor has the following rights in preparing the terms of the appeal when advocating the state's interests:

- To perform a revision of the municipalities, request and receive legal actions, documentation, and other information from the municipalities;
- To request and receive explanations from the officials of the local governments.

The mentioned responsibilities must not exceed the aim of appeals.

1.5 Publicity of Audit in the Municipalities

According to Articles 6 and 8 of the Law on Freedom of Information, each person has a right to request and examine information and/or to apply to the overseer of the information (in a manner prescribed by law), and have access to the information if it does not include a state, official, bank, or trade secret.

The Law on Auditing Performance defines those documents prepared by external auditors which include trade secrets. Thereby, according to the law, the auditor's opinion is not a trade secret. The publication of those documents is at the local self-government bodies' discretion. This means that the auditor's opinion is accessible to everybody.

In addition to the auditor's opinion, the external auditors may also prepare a report which may include information on the process of audit, mistakes and shortcomings, infringements of accounting rules, requirements for the preparation of financial statements, the results of particular issues analysis, as well as suggestions to correct the mistakes and shortcomings, etc.

This report is considered a document containing secret matters about national trade. It is used for administrative proposes.

The number of municipalities that somehow publish the results of audit is quite small (for example, via local newspapers or websites of the municipality, independent newspapers, indicator boards, local television, etc.). The results of internal audit have been published in three urban, zero rural, and one district municipality. The results of the external audit are as follow: only one urban, no rural, and one of the district municipalities have published the external audit's results.

It should be mentioned that the population, representatives of NGOs, and mass media do not usually use the right given them by the Law on Freedom of Information. Such instances have been recorded in only one urban and one rural municipality (where representatives of those municipalities' residents applied for the information).

1.6 Municipal Organizations

According to Article 52 of the Law on Local Self-government of the Republic of Armenia, by the decision of the municipal council, the municipality can establish organizations for the purposes of exercising its powers. The municipal institutions and organizations can be one of the following:

- 1) Budgetary institutions,
- 2) Commercial and non-commercial organizations completely owned by the municipality,
- 3) Commercial organizations with partial municipal ownership.

The budgetary institutions and non-commercial organizations are non-profit organizations. The budgetary institutions are created by the municipality to execute administrative, socio-cultural, educational, and other activities. The budgetary institutions are not legal entities and act in accordance with the statutes established by the municipality. The municipality is responsible for these institution's liabilities. The budgetary institution is totally financed by the municipal budget. It may not hold a bank account in commercial banks. The charges and fees (rates of which are established by the municipal council) collected for provided services are transferred to the municipal budget.

Conversely, non-commercial organizations are legal entities and can hold a bank account in commercial banks. They are also non-profit organizations. The expenditures for the implementation of their activities, defined by the non-commercial organization's statutes, are covered by fees collected for the provided services, and in case of default then from the municipal budget.

The Law on Local Self-government allows the municipalities to own commercial enterprises. Those legal entities (which are commercial organizations) can be created as partnerships or companies. The partnerships can be created as either absolute partnerships or trust-based partnerships. The companies can be created as limited-liability or additional-liability companies, as well as joint-stock companies.

According to Article 72 of the Civil Code of the Republic of Armenia, neither central nor local governments have the right to be shareholders of either partnerships or companies. According to Article 9 of the Law on Legal Acts, in all the spheres that are under the Civil Code's regulation, all the laws must be adapted to the Code's standards.

Nevertheless, in Armenia, as of May 1, 2006, there are 922 commercial organizations entirely or partly owned by municipalities.⁹

Commercial enterprises are profit-pursuing organizations. They are self-financing organizations. To ensure the provision of services with a view to improve the welfare of the population, tenders are organized in which the municipal commercial organization, acting in this sphere, participates. In this case, one of the conditions of the tender is the provision of the maximum fee rate as suggested by the municipality for provided services.

Both the internal and external audits performed in the municipalities may cover municipal organizations' financial affairs.

The results of the survey show that the majority of municipalities implemented internal audits in the years 2005, 2006, and 2007. The audit included budgetary institutions and non-commercial organizations. In respect to the commercial organizations, the situation is a little different. In but four urban, one district, and zero rural municipalities did the internal audit cover the municipal commercial organizations' activities.

In terms of the external audit: in 2005, 2006, and 2007 in respectively four, four again, and five urban; seven, five, and five district; and no rural municipalities did the external audit include the municipal budgetary institutions and non-commercial organizations. Regarding the municipal commercial organizations the situation is as follows: in 2005, the external audit covered the municipal non-commercial organizations' activities in only one urban municipality. There were no cases among the rural municipalities. In 2005, there were three, and in 2006/2007 there were two such cases within district municipalities (the 2007 data are still forthcoming at the time of writing).

1.7 Financial and Performance Audit

In the case of line-item budgeting, a financial audit is usually performed. It is performed to check the conformity of financial transactions with adopted rules and principles. In the case of performance budgeting, the performance outcomes are highlighted, and in this respect the audit expands its traditional scope. It also reflects achieved outcomes.¹⁰

1.8 Audit Standards

The main principles and essential procedures of the audit are prescribed by audit standards. These principles and procedures are used to perform audits of financial statements and other relevant information, as well as their accompanying services. These procedures and principles may be changed if necessary.¹¹

In Armenia, audit standards approved by a decree of the Minister of Finance and Economy (No. 324 on the Approval of Audit Standards) correspond to those standards issued by the International Federation of Accountants.

Audit principles, which are used by auditors to express their opinion on financial statements, are the same for every type of organization. The principles should not depend on the nature of the audited organizations, because the users of audited financial statements may demand the same quality of audit. As the audit standards define the main principles and procedures of audit, these standards may also be used during audit implementation in the municipalities, commercial, and non-commercial organizations, as well as budgetary institutions (which are under the municipalities' supervision). Nevertheless, it may be necessary to change or supplement some audit standards in order for them to correspond to specific conditions and legislative requirements of the public sector (particularly, of the local self-government system). The nature of cases that may require such explanations or supplementations is stated at the end of each standard. That part of the standard is called the "Appliance of the Standard in the Public Sector" (ASPS).

The financial statements of the municipalities and municipal organizations may include additional information, which may differ from the information included in the financial statements of private organizations (for instance, a comparison of the reporting period's actual expenditures with the maximum limits as defined by the legislation, the achievement of planned results, etc.). In such cases, it may be necessary to change audit procedures' nature, deadlines, and volume, as well as the auditor's opinion.

If the standard does not include the ASPS portion, all the essential statements of such standards may be applied in the public sector.

2. DEVELOPMENT OF HUMAN RESOURCES

2.1 Appraisal of Auditors' and Audit Beneficiaries' Training Needs

The professional qualifications and skills of the auditors (both external and internal) play a crucial role in the process of audit-function development within the local self-government system.

The external auditors contract independently with the municipalities for their work. The external audit in the municipalities may be implemented by either an auditing firm (a legal entity providing auditing services) or an individual auditor (a private entrepreneur). Article 6 of the Law on Auditing Performance states that all auditors (both professional auditing firms and individual auditors) may provide auditing services only if they are licensed by the state-authorized body (the Ministry of Finance and Economy). This means that the external auditors must be qualified in a manner prescribed by the state authority.

Internal auditors are employees of the municipalities. It is not yet compulsory for the internal auditors (or employees of the auditing unit) of the municipalities to be accredited in a manner prescribed by the state authorities. For this reason, we tried to assess the internal auditors' professional qualifications and the correspondence of those qualifications to their post.

There are state educational criteria for each profession, as defined by the state-authorized body (the Ministry of Education and Science). The criterion of each profession defines the basis for appraisal, the degree, and qualification of graduates from each higher educational institutions' particular profession. The higher education institutions each develop and approve their own curricula based on the state educational criteria.

Thus, according to the state's education criterion of "Accounting and Audit" (a Bachelor of Economics is required to qualify),¹² the graduate with the "Accounting and Audit" major gains complex knowledge concerning all the spheres of the economy. He or she is prepared for employment in the financial departments of state and local self-government bodies that perform professional activities like organization, management, control, audit, and analysis, etc.

The Law on Education of Armenia defines the basis according to which higher education institutions should follow the requirements of the state's education criteria. According to Article 44 of the Law on Education, private citizens can be employed in state bodies¹³ and non-commercial state organizations only if they have a diploma granted either by state or by privately-accredited education institutions. Accreditation of state-run education institutions and their professions is compulsory. There are several *mandatory* requirements for accreditation of the higher educational institutions. One of those requirements is that the institutions must ensure that the quality of education corresponds to the state educational criteria.

In fact, one may state that the qualification of graduates of state- and privately-accredited institutions with an "Accounting and Audit" major allows them to perform internal audit in the municipalities.

As of January 1, 2007, there are 16 state- and 35 privately-accredited higher education institutions, though only the following institutions have the "Accounting and Audit" major:

- State-run higher education institutions: Yerevan State University of Economy and Gavar State University;
- Privately-accredited higher educational institutions: Yerevan “MFB” Financial Academy, “Martig” University of Foreign Economic Affairs, Yerevan University after Mesrop Mashtots, and the “Yerevan International Center of Teaching of Accountants.”

We tried to ascertain the level of professional qualification, as well as the proficiency and skills of people performing internal audit in the municipalities, in order to appraise their ability in performing internal audit properly.¹⁴

In 28 urban municipalities that participated in the survey, all the head auditors have completed higher education (they are all economists). Of these, only six auditors are accountants by major. In all but six municipalities do the head auditors have a secondary education. Most of them are economists. There are also other specialists. The head auditors of two municipalities have higher education in disciplines other than economics.

It bears mentioning that this realm (i.e., audit at the local level) is beyond the focus of the different organizations that organize trainings. Only four municipalities' auditors (of 41 municipalities included in the survey) have participated in trainings.

Although appraisal of the proficiency and skills of the internal auditors is highly subjective, in most municipalities that mark is low.

The educational level of the head auditors is high within district municipalities. In all the district municipalities implementing internal audit, the head auditors have a degree in economics, and of those, four auditors are accountants by major. Head auditors of district municipalities have not participated in trainings, but the mark of the auditors' proficiency and skills is quite high (even excellent) in the district municipalities.

In two out of three of the rural municipalities that implement internal audit, the head auditors have a higher education degree. In the remaining municipality, the auditor has a secondary school education. The mark of the auditors' proficiency and skills is low in rural municipalities.

Aside from the auditors, it is also important to increase the level of awareness of audit beneficiaries (i.e., within the population, councilors and heads of the municipalities) of their rights and responsibilities, in order to develop audit functionality at the local level. This problem might be solved not only by state authorities and international organizations, but also by NGOs, which act either in the sphere of local governance or accounting and audit.

Currently, there are three major local government associations operating in Armenia: the Communities Finance Officers Association (CFOA), the Association of Municipal

Councilors of Armenia (AMCA), and the Republican Association of Communities of Armenia (RACA).¹⁵ These organizations act as legal entities. Their goals are to assist the development of the local self-government system.

The main tasks of the Communities Finance Officers Association are as follows:

- To participate in drafting legislation on local self-government;
- To exchange best practices in municipal financial management;
- To express the interests of local governments during meetings, seminars, conferences, and discussions organized by the CFOA and other organizations;
- To cooperate with foreign local self-governments, as well as public organizations, etc.

The CFOA also provides consultancy services to the municipalities. Municipal-budgeting software, created by the association, has already been purchased by many municipalities. The CFOA created a database for all Armenian municipalities. The association has organized many training seminars and conferences, and published many books on local self-government issues. The CFOA has also been cooperating and continues cooperation with many international and foreign organizations.

The main tasks of the Association of Municipal Councilors of Armenia are as follows:

- To harmonize council activities among municipalities of Armenia;
- To exchange best practices and information on current council activities;
- To promote the improvement of the legislation on local self-government;
- To encourage professional development among its membership;
- To carry out research and educational activities, etc.

Among its activities, the AMCA organized several training workshops for municipal councilors. The AMCA also cooperates with various international organizations.

The main tasks of the Republican Association of Communities of Armenia are as follows:

- To support forms of cooperation among municipalities;
- To promote improvement of the legislation on local self-government;
- To work together with similar foreign organizations and foster international relationships;
- To promote effective local self-government by providing information to local government officers, etc.

The Association of Accountants and Auditors of Armenia (AAAA) is a well-known organization in the realm of accounting and audit.

One of the main objectives of the AAAA is to ensure that the accounting and auditing profession in Armenia is recognized, at home and abroad, as both high quality and highly ethical.¹⁶ One of the key directives of the AAAA's policy is to obtain full membership in the International Federation of Accountants (IFAC).

The AAAA aims to bring knowledge and quality of work of all its members up to international standards, and requirements, and supervise this continuing process. This process guarantees the update of necessary knowledge, achieved through a variety of methods, and this variety gives AAAA members as flexible a mechanism as possible to improve their professional skills. The AAAA carries out an "Accountant's Qualification" program, which is well known by the population, not to mention by national and international professional institutions. The AAAA cooperates with higher-education institutions to improve the syllabi of "Accounting and Audit" departments.

CONCLUSIONS AND SUGGESTIONS

As a result of this survey, a picture of the audit in the local self-government system of Armenia could be composed in the following way:

- Internal audit is institutionalized within the frameworks of urban and district municipalities. This is not true for external audit. External audit, as an important tool for the improvement of the municipalities' accountability and transparency, does not yet serve its purposes;
- It is too soon to speak about audits within the rural municipalities of Armenia;
- There are many legislative omissions and contradictions preventing the development of the audit function at the local level. These omissions and contradictions give the interested sides an opportunity to maneuver;
- The level of awareness of civil society representatives and local self-government bodies on their rights and responsibilities is low;
- External auditors tend to have a high level of proficiency and skill. The same is not true for internal auditors. The proper qualification and training of internal auditors is not yet provided;
- State authorities in the realm of state control at the local level are vested with a large array of powers. As a result, one of the key principles of local governance—sovereignty—is violated;

- Currently, in Armenia, audit is mainly concentrated on a simple financial audit. International practice where the scope and type of audits is much wider, would also include a performance audit.

The following steps are suggested for the further development of the audit function in the local self-government system of Armenia:

- Remove contradictions and omissions in the current legislation;
- Increase the awareness of the representatives of civil society and local self-government bodies of their rights and responsibilities;
- Organize trainings for the internal auditors;
- Create a strong relationship between local governments and NGOs to ensure the advocacy of the local self-government bodies' rights;
- Extend the scope of audit to include a performance audit.

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- ¹ D. Tumanyan (2006) Local Self-government in the Republic of Armenia, Yerevan.
- ² Before adoption of amendments in the Law on the Administrative Territorial Division of Armenia (June 13, 2006) there were 931 municipalities.
- ³ Tumanyan D. (2007) Training materials for the “Operational and Capital Planning and Budgeting” project (RTI/LGP3, CFOA).
- ⁴ Tumanyan D. and V. Movsisyan (2006) Performance Budgeting in Local Self-government System, Yerevan.
- ⁵ The internal audit performance plan is approved at the end of the previous year. Due to this, the survey includes 2007 as well.
- ⁶ The municipalities can channel these amounts to financing the programs as agreed with the central government. Literally, according to the procedures established by the central government of the Republic of Armenia.
- ⁷ The control in terms of legality is limited by the checking the accordance of the powers’ execution of the laws.
- ⁸ The professional control aims to check the powers execution’s legality, effectiveness, and completeness.
- ⁹ D. Tumanyan (2006) Local Self-government in the Republic of Armenia, Yerevan.
- ¹⁰ D. Tumanyan and V. Movsisyan (2006) Performance Budgeting in Local Self-government System, Yerevan.
- ¹¹ Audit standard 120 “Frames of Audit Standards.”
- ¹² A bachelor’s degree is the first degree of professional qualification.
- ¹³ The idea of “state body” is not commented on by this law. Experience shows that by saying “state body” Armenian laws mainly mean both state and local self-government bodies.
- ¹⁴ Internal audit is performed either by the head auditor or by an audit committee (which guides the head auditor) in the municipalities. The committee’s membership is not sustainable. For this reason, only the committee head’s proficiency and skills were measured in this survey.
- ¹⁵ D. Tumanyan (2006) Local Self-government in the Republic of Armenia, Yerevan.
- ¹⁶ Available online: <http://www.aaaa.am>.

Report on the Audit of the Local Government's Financial Management in Azerbaijan

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FOREWORD

Auditing in Azerbaijan mainly aims at obtaining reasonable assurances as to whether or not the financial statements of economic entities are free of material misstatement. Historically, audit was associated directly with the interests of firms and their owners. Yet there has been a pressing need to audit the financial affairs of governments in Azerbaijan as well as its neighbors. This is also accompanied by the improvement of fiscal transparency and accountability by promoting the proper practice of auditing and the enhancement of efficiency of government management.

Local governments' financial management is markedly different from its congruent system in the business sector, because the accounting of the private sector must provide for profits and losses and prevailing market conditions. But the functioning of local government is limited to subventions from the national budget and chiefly aims at providing public services rather than profit-making. Therefore, the accounting standards used by local governments must cover and/or reveal what money has been budgeted and spent and the realities of budget execution as a major mechanism for the management of financial resources.

With adequate scrutiny, an audit reports on the effectiveness of the accounting system in its results and highlights full and factual information on how the efficiency of forecast receipts and expenditures has or has not been enhanced and how financial operations are performed in view of overall financial management in local government units.

Audits are useful in that they assess factual financial needs and allow us to manage and implement multiple social and economic programs of local governments, while providing a degree of fiscal transparency and measuring the efficiency and effectiveness of the programs already implemented by local governments.

Three potential groups of users are expected to make use of this information. The *external users* of the financial information include local communities, donors and funders, and sellers of goods (work, services) for local governments. The *internal users* include specialists employed by local bodies (financial managers and experts in charge of supervising budget planning). The last group of *information users* is a key factor in greatly enhancing the performance of local governments, yet this group has not been directly involved in their daily function. It consists of state-run structures rendering subventions to local governments in diverse forms, as well as legislative structures. The former may require a special accountability system to check how far the use of the subventions is effective.

1. THE SYSTEM OF LOCAL GOVERNMENT AUDIT IN AZERBAIJAN AND TYPES OF AUDIT SERVICES

The system of both central and local government audit in Azerbaijan, like most of the transition countries, has been shaped hastily since the 1990s.

Local government audit is a complicated process facing unique difficulties. This is chiefly due to the presence of numerous local government bodies that are different in nature and serve distinctive functions within one administrative and territorial unit.

For example, under the Republic of Azerbaijan's Constitution, the authority of the local executive power is determined by the President of the Republic of Azerbaijan. Municipalities, formed through elections, should perform the duties of local government. Suffice it to say, that the number of institutions undertaking functions in accordance with the concept of "local government" approaches 2,850 (including 85 executive powers in individual regions [towns] and 2,757 municipalities). Given this situation, the practice of the audit function in local government is difficult. Nevertheless, the number of central government bodies acting as executives of budgetary funds (ministries, committees, government agencies, etc.) does not even reach 100.

In Azerbaijan, local government audit is regulated by corresponding legislative acts. The following are the major normative-legal documents on local government audit:¹

- 1) The Republic of Azerbaijan's Law on the Chamber of Auditors, dated December 7, 2001.
- 2) The Republic of Azerbaijan's Law approving the Internal Charter of the Chamber of Auditors of the Azerbaijan Republic, dated March 5, 2002.
- 3) The Republic of Azerbaijan's Law No. 882 on Auditor Services, dated September 16, 2003.
- 4) Resolution 009 of the Cabinet of Ministers of the Azerbaijan Republic, on approval of procedures for issuance of special permits (licenses) for involvement in audit activities in the Azerbaijan Republic, dated January 13, 1998.
- 5) Audit Standards No. 42/1, approved by the Board of the Chamber of Auditors of the Azerbaijan Republic and dated December 7, 1999.
- 6) Resolution 38-I QR of the Milli Mejlis (National Assembly) of the Azerbaijan Republic on State Registration of Independent Auditors and Audit Companies, dated March 12, 1996.
- 7) Resolution 1115 of Milli Mejlis of the Azerbaijan Republic, on approval of the Charter of the Chamber of Auditors of the Azerbaijan Republic, dated September 19, 1995.

- 8) Resolution 159/5 on the recommended minimum limits of the cost of audit services, approved by the Board of the Chamber of Auditors of the Azerbaijan Republic, dated December 23, 2005.
- 9) Azerbaijan's Law on Administrative Control of the Activities of Auditors, dated May 13, 2003.
- 10) Law No. 358-II QD on the Budget System of the Azerbaijan Republic (Articles 11, 22, and 39), dated July 2, 2002.
- 11) Law of the Republic of Azerbaijan on Accounting, dated June 29, 2004.

Additionally, there are multiple secondary normative/standard acts (rules and regulations of individual government and state audit bodies) regulating the scrutiny of local governments' financial management. The most important requirements of these documents will be detailed throughout this report when needed.

In international practice, there are different forms of audit services: internal and external audit.

- **Internal audit** functions as an independent structure within local government, and much of its performance is based on the local government's system of internal control. The internal auditors report to local governments.

The primary functions of internal auditing extend to the oversight of use of funds, avoidance of unnecessary costs, confirmation of the accuracy of the information local government's management use for decision-making, oversight of the accuracy of economic operations, analysis of fiscal performance efficiency and proposals for its enhancement, and data-quality assessment for management systems.

- The **external audit** program involves engaging an independent auditor to assess the local government's activity and accountability. Here, it is worth speaking only about external audit of local governments in Azerbaijan. Because the legislation already fails, in effect, to take into account the establishment of internal audit bodies or the structures performing financial control, Resolution No. 138, dated June 16, 1999, on Local Executive Authority, establishes standard structures of said local authority. According to the legislation, a Local Executive Authority shall be comprised of 21 divisions, departments, and services (legal, software, information, etc). However, the legal framework does not provide for any financial entity. Moreover, item 3.3.3 of the International Monetary Fund's (IMF) guidelines to ensure transparency in the budget and tax system shows that the internal audit of an individual government's affairs is one of the key means to prevent the misuse of funds and to guard against inadequate management. The bank experts, however, claim that not only should the internal audit procedures be made available to the public, but external auditors should also be allowed to assess their efficiency and viability.²

The state of internal audit in municipal companies is similar. In fact, no institutional or policy framework guiding the activity of local self-government in Azerbaijan encompasses the establishment of the internal audit system in municipalities. For example, the functions vested to municipal councils—which perform the major functions of local self-government structures, executive power of municipalities, and standing commissions—exclude well-established norms for the internal audit of municipalities. Only Article 13.1 of the Law on the Financial Basis for Municipalities roughly stipulates that municipal bodies have control over the local budget’s execution. This is a much more speculative legal norm: it is not obvious which municipal structures should scrutinize it and what forms of scrutiny should be used. In another example, under Article 12.1 of the Law on Local (Municipal) Taxes, the financial activity of municipalities should be scrutinized by review commissions, comprised of community members, who are subject to approval in municipality meetings. This is not a professional audit of municipal bodies, but purely a community audit. Finally, such legal uncertainty associated with internal audit is reflected in the Presidential Decree of June 4, 2001 on Rules for Placement of Municipal Orders. Item 7 of the legal document states that control over placement and execution of municipal orders is carried out by municipalities, but it does not reveal how and on what municipal structure this control should be exercised.

This investigation will only cover issues of external audit in local government. In Azerbaijan, the external audit is carried out by two bodies:

- 1) The Chamber of Accounts of the Azerbaijan Republic
- 2) The Chamber of Auditors of the Azerbaijan Republic

The Accounts Chamber is a state-run legal entity, while the Chamber of Auditors, being a financial institution, is an independent audit body.

Additionally, Azerbaijan’s Finance Ministry has the right to control the use of State Budget subventions to local governments. Therefore, it is essential to clarify the principles and duties of financial audit in local governments that are provided by the Finance Ministry.

1.1 Local Government Audit Carried out by the Chamber of Accounts

State audit bodies auditing the financial affairs of local governments function under different names in different countries across the world. They are, for example, called the Supreme Auditing Department in some countries, and the Central Accounts Chamber in another. In Azerbaijan, the body implementing state audit is called the Accounts Chamber as it is in French-speaking countries. The existing legislative framework extends

to adequate scrutiny of local governments' financial management by the Accounts Chamber. However, the types of the audit service in relation to executive councils and municipal bodies are different.

a) Local Executive Council Audit Carried out by the Chamber of Accounts

Under Article 2 of the Law of the Republic of Azerbaijan on the Chamber of Accounts, state audit of local executive powers covers the following:

- accurate spending of State Budget subventions;
- effective spending of off-budget revenues by local governments;
- targeted spending of budgetary allocations;
- accurate drawing up of credit provided to local governments;
- management of state property, the supervision over the issue of orders, and transfer of means from privatization to the State Budget.

The state audit of local executive powers/councils not only extends to State Budget funds and subventions, but also to more extensive financial activities. It is worth noting that State Budget funds allocated to local executive authorities in Azerbaijan are divided into two groups: the first group includes means formed on the basis of state tax (payments) collected directly in the catchment areas (of district/city executive authorities); the second group includes State Budget allocations to local executive authorities on a normative basis in order to realize concrete activities and targeted state programs.

Let's consider a concrete, fairly recent example of the practices of audit in local executive authorities the Chamber of Accounts. In 2005, the Chamber of Accounts audited the execution of the funds allocated to the Housing and Communal Services at Baku's Executive Power on expenditure under the functional section "Housing and Communal Services" of the State Budget.³ The audit revealed that AZN 4.97 million was to be allocated to the department in 2005, yet the cash receipt execution was AZN 4.93 million. It also revealed that as the department was not able to collect fees for communal utilities and other services—it had losses of AZN 4.02 million. During the second half of 2004, the Chamber of Accounts audited the execution of funds allocated to the Main Capital Construction and Repair Department of Baku's executive power on expenditure under the functional section "Industrial and Construction Expenditures" of the State Budget.⁴ But the Accounts Chamber neither places relevant information on its website, nor do those reports available to the public contain the results of the monitoring. It is only reported that the audit was carried out.

b) Local Government Audit Carried out by the Chamber of Accounts

The Law on the Chamber of Accounts also provides for scrutiny of local governments' financial management. Under Article 16 on the Authority of the Chamber of Accounts to Perform Financial/Budgetary Expertise of the said law:

[...] the Chamber of Accounts has the authority to perform the financial/budgetary expertise, prepare a conclusion, and give relevant proposals on the basis of inquiries of the Justice Ministry. The Chamber of Accounts, if deemed necessary, can perform audit of enterprises and organizations in the course of analysis of the income and expenditures of the State Budget and extrabudgetary state funds (institutions).

However, the specific cases of necessity for local government audit have not been reflected in appropriate legislative acts.

The Chamber of Accounts cannot only audit State Budget funds, but also local budgets on the whole. As per Article 6 of the Law on the Administrative Control over the Activity of Municipalities, use of State Budget funds, owning municipal property, its fees and use, application of lump-sum local taxes and dues, expenses for municipalities, and issues causing financial liabilities are the subject of administrative control over municipalities. Thus, should the Justice Ministry face a problem with a municipal body during the control process, it may invite the Chamber of Accounts to audit the said issues. For example, the Chamber of Accounts audited Baku's Hatai District Municipality last year in accordance with Letter No. 09/2-63 dated March 29, 2006 from the Justice Ministry's Center for Work with Municipalities. The audit process aimed at verifying the accuracy of spending State Budget grants and subventions, as well as the means allotted from private sources over the past four years, including 2006.

The audit revealed a number of legal wrongdoings. For example, it revealed that although AZN 17,000 had to be spent on the purchase of vehicles from the approved 2005 budget, AZN 44,100 of budgetary means had been spent during the year without changes to the budget; or when selling land plots to citizens, in most cases the price of land shown in the sale agreements was below the statutory tariff. It was thus revealed that, as a result of reduced prices, AZN 32,100 had not been allocated to the Hatai Municipality budget during the audit period. In addition, the audit also revealed that no lease agreements had been concluded in some cases when municipal land was leased to trade and service facilities, but payments proceeded unofficially.⁵

The Chamber of Accounts fails to seek an answer as to how far the State Budget under the disposal of local executive authorities, and local budget funds that constitute the financial base of municipalities, are effective. Such audits should resolve one question only: was the actual budget execution congruent with approved budget estimates? If no deviation is discovered as a result of inspection, the auditor issues a positive assessment.

c) Accountability of the Accounts Chamber for Audit in Local Government

The Milli Mejlis (Parliament) creates the Chamber of Accounts based on Article 92 of the Constitution of the Republic of Azerbaijan. According to Article 1 (the Status of the Chamber of Accounts of the Republic of Azerbaijan) of the Law of the Republic of Azerbaijan on the Chamber of Accounts, "The Chamber of Accounts is a full-time State Budget and finance-supervising body, which reports to the Parliament." Article 2 (Main Functions of the Chamber of Accounts) of the said law states that the Chamber of Accounts shall promote the Milli Mejlis to supervise the approval and execution of revenue and expenditure items of the State Budget.

Under Article 92 (Coordination of Work of the Milli Mejlis of the Azerbaijan Republic) of the Constitution of the Azerbaijan Republic, which came into force as of November 27, 1995, "the Milli Mejlis of the Azerbaijan Republic shall set up the procedure of its work; it also shall choose the chairperson and its assistants, organize permanent and other commissions, and set up the Counting Chamber." Additionally, according to Article 8 (on the chairman of the Chamber of Accounts) of the Law of the Republic of Azerbaijan on the Chamber of Accounts, "The chairman of the Chamber of Accounts shall report twice a year (spring session, not later than April 15; autumn session, not later than October 15) to Parliament on the performance of the Chamber of Accounts." Thus, the Chamber of Accounts reports to Parliament, but not to executive councils.

The existing legislative framework does not provide for the accountability of the Supreme Audit Body before the media or civil society institutions in a compulsory manner. Article 21 of the Law of the Republic of Azerbaijan on the Chamber of Accounts is called "Promulgation of Information on the Activities of the Chamber of Accounts." It states: "The Chamber of Accounts regularly informs the mass media on its activities. The reports on the activities of the Chamber of Accounts are submitted to Parliament and published in the *Official Gazette*."

For reference, the directory of the *Milli Mejlis* is distributed to members of Parliament and superior state bodies only (the public have no access to it). The normative documents of the Chamber of Accounts that regulate its activity not only leave out the accountability of this Supreme Audit Body before civil society (including media), but this body also fails to file reports on the results of the audit and expertise actions involving state administration structures, as well as municipalities, on its official website (www.ach.gov.az). There, we can find its recent reports covering 2002–2003. To put it more precisely, the latest information filed is about the execution of State Budget of 2003, covering the year's first quarter. The Report on the Activity of the Chamber of Accounts is distributed annually to members of Parliament. NGOs usually access the documents through unofficial contacts.

1.2 Conditions for Local Government Audit Delivered by the Chamber of Auditors of the Azerbaijan Republic

In addition to the Chamber of Accounts, that is, the State Audit body, there is an external audit within the Chamber of Auditors of the Azerbaijan Republic, which carries out an independent check of the accuracy of financial accounts, statements, and reports in entities dealing with the production and sale of goods, the delivery of services, and contracts.

The Chamber of Auditors is an independent financial structure responsible for the regulation and development of audit services at the government level, supporting proprietary rights of property owners; supporting the interests of government, businesses, and auditors (audit companies); and ensuring that the rules and procedures stipulated by legislative acts are observed by independent auditors and audit companies. Under Article 3 (Audit Services) of the Law on Auditor Services of the Azerbaijan Republic, dated September 16, 1994:

Audit services include performance (based on mutual agreement) of check, expertise, and analysis of financial and business performance of entities with further issuance of reports, statements, and confirmation of accuracy of company's financial reports and provision of other services within the responsibilities of auditor.

Such audit should, for instance, assess the financial accountability of local government, and the compliance of the accounting system with the existing legislation, instead of auditing how efficiently local governments use public money.

Under the legislation already in effect, both an independent auditor and an audit company can be employed for external audit in Azerbaijan. An independent auditor is a physical person granted rights to deliver audit services on the territory of the Azerbaijan Republic and licensed by the Chamber of Auditors of the Azerbaijan Republic. An audit company is a legal entity granted rights to deliver audit services on the territory of the Azerbaijan Republic and also licensed by the Chamber of Auditors, and for which the delivery of its audit services is determined according to its charter. Independent auditors and audit companies can provide services or run business for five-year terms after receipt of their licenses upon registration by the corresponding state office in the republic.

Issuance of licenses for audit services is subject to Resolution No. 009 on the issue of special permits (licenses) for involvement in audit activities in the Azerbaijan Republic, dated January 13, 1998, of the Cabinet of Ministers of the Azerbaijan Republic.⁶

Independent auditors should be registered in a corresponding state office in order to start a private business without forming a legal entity. The auditor shall have right to start delivery of audit services from the moment he/she is awarded an audit license. Under Article 6 (Who Can Be an Independent Auditor?) of the Law on Auditor Services of the Azerbaijan Republic, the terms of becoming an independent auditor are: a) citizenship in the Azerbaijan Republic; b) a clear criminal record free from obligations (connected

to fraud or other criminal behavior) or previous banishment from financial positions or involvement in similar activities; c) education in accounting, finance, economics, or law, and a minimum of three years' professional work experience in the respective areas; d) passing an examination for an independent auditor license.

The organization of license examinations to become an auditor is implemented in accordance with the provisions of the Charter of the Republic of Azerbaijan's Chamber of Auditors, as approved by Milli Mejlis on September 19, 1995. Under Articles 15–18 of the Charter, the license examinations are held by Licensing Commission formed by the Chamber. The Licensing Commission is formed of three representatives from the Chamber, one representative each from the Ministry of Finance of the Azerbaijan Republic, the State Tax Office, the National Bank of Azerbaijan, a consultant professor of economics, a representative of independent auditors, and a representative of the audit companies. The contents of the licensing exam are announced by the chairman at the beginning of the year. Additionally, members of the Licensing Commission should be very experienced in audit, and have no less than 10 years' experience in one of the related disciplines such as accounting, financial control, economics, or law.

Under Article 2 (Audit Concept) of the Law on Auditor Services, audit can be mandatory and voluntary (by entity's initiative). Audit is mandatory if it is conducted in entities that should publish their financial reports pursuant to country legislation, or in cases stipulated by country laws, or by the instruction of authorized state office, and is voluntary in all other cases.⁷ Consider the Law on Banks of the Republic of Azerbaijan, dated January 16, 2004. Under Article 45 (Publication of Balance Sheet and External Auditor's Opinion) of said law, each bank and domestic branch office of foreign banks shall, not later than five months after the end of each of its fiscal year, submit to its shareholders and make available for the public upon request its audited consolidated financial statements, together with the report of the external auditor, for that financial year (Sub-Item 45.1) and each bank shall, not later than five months after the end of each of its fiscal year, submit to the National Bank its audited consolidated financial statements, together with the report of the external auditor, for that fiscal year. Each foreign bank with one or more domestic representative office shall submit to the National Bank its audited financial statements, accompanied by the external auditor's report, no later than five months after the end of the fiscal year, and its consolidated financial reports, accompanied by the external auditor's report, no later than eight months after the end of fiscal year (Sub-Item 45.2). And under Sub-Article 45.3. of the law, the financial statements referred to in Article 45.1 hereof, shall be published by the bank and the domestic branch office of foreign bank in the press, in detail, and at such a time as prescribed by the National Bank.⁸

Regarding local government audit services delivered by independent auditors, the requirements of the law in relation to executive councils and municipal companies differ.

a) Local Executive Council Audit Carried out by the Chamber of Auditors

All the effective legislative acts of the Republic of Azerbaijan, and notably the Provision/Resolution on Local Executive Authority, adopted June 16, 1999, fail to take into account external audit of executive bodies, in addition to state audit.

The financial affairs of local executive authorities are audited by two entities only: the Finance Ministry and the Chamber of Accounts. Despite this, several state bodies, such as the Presidential Administration, the Office of Public Prosecutor, the Ministry of Interior (MoI), and other state-run public authorities may employ the Chamber of Auditors should the need arise for financial expertise while monitoring the activity of local executive bodies.

b) Municipal Audit Carried out by the Chamber of Auditors

In accordance with the current legislation effective in the Republic of Azerbaijan, municipalities are included in the category of economic entities that are required to make financial reports to the public and authorized state offices. Almost certainly, the publication of the accounting (financial) reports of the local governments is far from accurate. For example, under subparagraph 37.7 (Article 37, Execution of the Local Budget) of the Law of Azerbaijan Republic on Budget Systems, dated July 2, 2002, the annual report on the execution of local budgets should be approved in a manner determined by the regulations of the municipalities, and the population living in the municipal area should be informed about this. At the same time, under Article 14.2 of the Law of the Azerbaijan Republic on Accounting, the number of inventories within a reporting year, date of implementation, list of property, and liabilities to be inspected during inventory shall be determined by a municipal enterprise. The point at issue is that regulations of municipalities have been created based on the Law of the Azerbaijan Republic, on the approval of model regulations of municipalities, dated October 15, 1999. The document is in a standard format.

The model regulations, which consist of 12 articles, do not reflect any information about the financial accountability of the municipalities. Under Article 12.3 of the Law of the Azerbaijan Republic on Local (Municipal) Taxes and Payments, dated December 27, 2001, the municipalities should supervise the formation and use of budget receipts by ensuring transparency in this area. Additionally, they should publish bulletins and post the reports on special bulletin boards in front of municipal office buildings.

Because the publication of the financial reports is not always accurate, the municipalities should be audited once a year (in accordance with the preparation and submission of the annual report on budget execution) subject to the existing law. As per Article 39.1 (Supervision over the Local Budget) of the Law of Azerbaijan Republic on Budget Systems), as well as Article 12.2 of the Law on Local (Municipal) Taxes and Payments, each municipality should supervise the local budget execution, including its correspon-

dence to the resources spent, with the approved budget indicators, and to this end has a right to involve independent auditors.

Additionally, there are other provisions in the already-effective legislation ensuring coercive actions for the monitoring of municipalities by independent auditors. Because under item 8.6 of the Law on Municipal Finance, part of budget expenditures not financed by local budget resources (local budget deficits) can be covered through allotting State Budget subsidies and subventions.

Furthermore, under Article 32.2.2 of the Law of Azerbaijan Republic on Budget Systems, financial support of the state to local budgets is achieved through allocating subsidies and subventions from the State Budget, when it is impossible to finance local socioeconomic development programs with local budget funds.

Under Subparagraph 11.14 of the said law, the municipalities that require the financial support from the State Budget no later than May 1 of the current year shall submit the auditor's opinion to the Finance Ministry. Members of the Auditors Chamber render auditing services instead of the appropriate payment.

The cost of the services has been fixed under Resolution No. 159/5 of the Board of Audit Chamber of the Azerbaijan Republic on Approval of the Minimum Cost of the Audit Service, dated December 23, 2005.⁹ According to the resolution, the minimum cost of annual audit services shall be differentiated as following, depending on the amount of the annual municipal budget:

- The cost of audit services shall be fixed in the amount of USD 100 should the annual budget amount reaches USD 5,000.
- The cost of audit services shall be fixed in the amount of USD 300 should the annual budget amount range from USD 5,000.1 to USD 10,000.
- The cost of audit services shall be fixed in the amount of USD 500 should the annual budget amount range from USD 10,000.1 to USD 20,000.
- The cost of audit services shall be fixed in the amount of USD 1,000 should the annual budget amount exceeds USD 20,000.

The Audit Chamber has the right to review and change the cost of audit services on a regular basis.

c) Municipal Enterprises' Audit and their Accountability

According to Article 34 of the Law of the Azerbaijan Republic on the Status of Municipalities, dated July 2, 34 local governments¹⁰ in Azerbaijan have the right to form legal entities. There are no limitations for state registration of municipal entities and companies: they can start delivery of services, having been registered in a corresponding state office in compliance with general procedures applied to other enterprises

and organizations regardless of property, organizational, and legal forms. The legislation does not stipulate any limitation or restrictions on the profile of the municipal enterprises/companies: they can engage in all sorts of activities, unrestricted by Azerbaijan legislation. Under Article 35 of the said law, the activity of municipal companies is based on the following principles and conditions:

- 1) Municipal companies are independent legal entities. Their relations with municipalities are provided through labor and civil legislation.
- 2) The objectives and conditions of municipal companies and enterprises are defined by the municipalities.
- 3) Prices (tariffs) of their goods (services) are adjusted by the municipalities, and the chiefs are appointed and released by municipalities.

Regarding municipal company accountability, according to Article 35 of the Law on the Status of the Municipalities, municipal companies, first of all, should report to the municipalities. The reports must cover each company's production (service) activity as well as financial results. In addition, the accountability of the said economic subjects has been collated exactly and governed by the Resolution of the Cabinet of Ministers "on approval of registration rules for indicators of municipal enterprises and companies' financial and economic activity," dated January 12, 2000.¹¹ Under paragraphs three and four of the resolution, municipal enterprises should submit quarterly and annual reports on local budget execution to the State Statistics Committee of the Azerbaijan Republic, while quarterly and annual financial reports go to the local structures of the Finances Ministry. The financial reports reflect the prognosis for local budget receipts and expenditures, as well as their present state of affairs.

Municipal company audit is voluntary. The audit can be conducted at the initiative of the municipal company or the municipality.

1.3 Financial Scrutiny of Local Governments by the Ministry of Finance (MoF)

Although the Ministry of Finance (MoF) is not an audit entity in terms of its functional goal and status, it is entitled by local legislations to perform control over local governments' financial management. The Central Department of State Financial Inspection, under the Ministry of Finance (MoF), exists for that purpose, and the activity of local governments is inspected/audited through this body. There are two main documents the legislative framework of which comprise the legal basis for such scrutiny:

- 1) Policy on the Activities of the Financial Ministry, approved by Decree No. 271 of the President of Azerbaijan, dated February 4, 2000.

- 2) Regulations on the Rules for the Implementation of State Financial Control by the Finance Ministry, registered by the Justice Ministry of the Republic of Azerbaijan, dated July 2, 2000.

It is also noteworthy that the MoF has the right, without exception, to perform control over local executive authorities' financial management, while its control over the municipalities is limited. Because, according to Article 1.1.14 of the Law on the Budget System of the Republic of Azerbaijan, donations (gratis financial resources provided from the State Budget to the local budgets) are allocated in order to balance their revenues and expenditures. That is to say, municipalities are fully independent in the preparation, approval, and execution of the local budgets. Therefore, subsidies cannot be subject to inspection by the Ministry of Finance. However, according to Article 1.1.16 and 1.1.17 of the above-mentioned law, subventions and subsidies are provided from the State Budget to the local budgets for financing special-purpose events, which are to be retrieved if not spent for these purposes or within a determined period of time.

Also, according to Article 39 (Supervision over the Local Budget) of the said law, in order to ensure the fulfillment of powers that have been given to municipalities by the legislative and executive bodies, supervision over the spending of the allocated resources shall be done by these bodies. Only subventions and subsidies that have been provided from the State Budget to the local budgets over the past eight years, since the establishment of local governments. No targeted funds have been allocated to the local budgets thus far. Therefore, the following remarks on the inspection of the local governments' financial activity, performed by the Ministry of Finance, extend to the local executive authorities only.

Paragraphs two and three of the policy on the activity of the Finance Ministry define the duties and functions of the Ministry. One of the chief duties of the ministry is to ensure control over budget funding and spending, pursuant to paragraph 2.6 of the policy, while paragraph three lists functions vested to the ministry. Under paragraph 3.8 of the document, the ministry exerts control over budget funds' allocation and their spending in accordance with the budget agreed upon with the appropriate financial bodies and effective use of approved budget allocations spent to finance investment and innovation programs. Furthermore, it drafts recommendations to the authorized state bodies in the instance of the misuse of State Budget funds during local government inspection. It also governs the organizational/methodological provision of the activity of the said bodies, and promotes the implementation of European accounting standards. According to Article 14 and items six and seven of the regulations, the Finance Ministry shall perform financial control over the executive councils in the villages and settlements at least once a year, whereas in cities and territorial executive branches, through its regional (city) branches (currently, it has 77 branches) at least once every two years.

The inspection's scope comprises the following:

- 1) Under Article 16 of the policy, the accuracy of approved budget funds' spending shall be audited with a view to pay the cost of construction and repair operations financed through the budget funds of local governments. The inspection is carried out by an inspection team organized by the Central Department of State Financial Inspection. The team is comprised of qualified specialists specializing in the repair/construction sector. The inspection focuses on the full accuracy of accounting operations, final figures, and the application of single normative rates in the acts, as per form No. 2 on spending of funds allocated to capital construction and repair activities, and on 40 percent of actual volume of the construction and repair works by a selection method.
- 2) Special attention is given to the inspection of construction and repair works done through tender bidding. In this situation, the inspection team audits the lawful calculation of estimated value of the work to be implemented by the tender announcer, compliance of the actual work performed by the tender announcer with that shown in the calculations stipulating the estimated value, delivery of work execution, and compliance with rules and conditions on payment of the cost as defined by the tender announcer, and finally any agreement attained between the tender announcer and winner whether the cost of work in the contract is plus or minus 10 percent. If it is revealed that the difference between contractual and actual work is at a rate exceeds 1,000 times the minimum salary rate,¹² all the facilities of the entity are impacted by the inspection.

At present, it is impossible to access information on the audit results from any official source, notably the official website of the Ministry of Finance¹³ from which such reports are unavailable to the general public.

2. THE DEVELOPMENT OF ENTITIES DELIVERING LOCAL GOVERNMENT AUDIT SERVICES IN AZERBAIJAN AND STAFF RESOURCES

Universally, both internal and external audit quality depend upon the formation of professional entities delivering the audit services and on qualified and competent staff resources. Auditing is a complicated area: the auditors, in addition to financial issues, must be well versed in economic issues on a whole, including current legislation. can we positively assess the activity of audit institution in Azerbaijan? Let's answer some questions that will enable us to reveal the real condition of both external and internal audit in local governments. A key point regards what legal requirements have been established in terms of the audit organization and activities.

Local governments in Azerbaijan are lacking an internal audit system. The best example of an internal institution is the banking sector. Quite specifically, the document “Standards on Internal Audit (SIAs)” approved by Protocol No. 24 of the National Bank of Azerbaijan, dated December 29, 1994, envisages the formation of internal audit structures in all banks, regardless of the type of property. According to the document, the internal audit department in the banks oversees the bank's activity to ensure compliance with the effective legislation, as well as normative acts issued by the National Bank of Azerbaijan, the bank's risk adjustment and management, high-quality procedures in preparing and applying bank operations, and the adequacy and precision of accounting information.

But today, Azerbaijan lacks the appropriate tools required for the formation of the internal audit of local governments. The question is about the system encompassing the education of internal auditors in the regulations, and about internal control over local governments, adoption of professional norms and standards, and the development of administrative procedures required for internal auditors. Therefore, when speaking about audit requirements, the focus once again will be on external audit.

The requirements concerning the member of the Chamber of Accounts are stipulated by Article 7 (Additional Arrangements with Regards to the Members) of the Law of the Republic of Azerbaijan on the Chamber of Accounts that defines the status, functions, organizational structure, and forms and principles of the activities of the Chamber of Accounts of the Republic of Azerbaijan. It states that, “persons that have higher education and five years' experience of work in the field of public administration, state control, economy, and finance are eligible for the positions of the chairman, deputy chairman, and auditors of the Chamber of Accounts. The chairman, deputy chairman, and auditors of the Chamber of Accounts cannot be involved in any kind activities that envisage any payment for the performed work, unless this is pedagogic, scientific, or creative activity. Auditors are elected for the term of seven years by MPs by an overwhelming majority.” Although the legislation stipulates that the Chamber of Accounts is an independent body and reports to the Milli Mejlis (Parliament), the real situation is completely different, as the Milli Mejlis it reports to also depends on executive bodies.

Elections to the legislative body are formal. In fact, MPs are elected by the supreme executive authorities. This is testified to by remarks in the reports of the body: under Article 16 (the Authority of the Chamber of Accounts to Perform Financial/Budgetary Expertise) of the Law of on the Chamber of Accounts, to audit the use of State Budget subsidies in Baku's several municipalities. The Chamber of Accounts included this in its Work Plan 2006, which was based on an appeal made by the Standing Commission for Regional Issues in Parliament, and was performed in connection with the execution of the task stipulated by the State Anti-corruption Program, as well as given possible arrears revealed in Baku's Hatai Municipality.

It was revealed that chief municipal officers (except in Nesimi Municipality) had impeded the audit group that aimed at implementing control measures. As a result, the decision the Chamber of Accounts adopted in its meeting on September 9, 2006 was not executed. According to Section 1, Article 1 of the Law on Administrative Control over the Activity of Municipalities,” administrative control over municipalities is an activity that targets and ensures compliance with the Constitution and laws of the Azerbaijan Republic, decrees enacted by President of Azerbaijan, and resolutions issued by the Cabinet of Ministers of the Azerbaijan Republic by municipalities, municipal bodies, and responsible municipal officers; to prevent breaches of law in municipalities.

Referring to the said clause of the law, Letter 2/4-04-397, dated September 12, 2006, was delivered to the Ministry of Justice’s Center for Work with Municipalities, seeking assistance for control measures. Yet conditions have not yet been created to address implementation.¹⁴ If the structure centralized in the Justice Ministry fails to promote the Supreme Audit Body for scrutiny of the municipalities, it not worth citing additional evidence to prove how weak this structure is in its position in relation to the executive bodies.

Additionally, if it is impossible to access the website of the Accounts Chamber, and its annual State Budget execution reports for the past four years, the results of audits delivered in state-run entities, as well as local governments, raises questions about its independence.

The professional requirements of the Chamber of Auditors are a key provision. Clause V (the Organization of License Examinations) of the Charter of the Chamber of Auditors defines the requirements as the following:

- 1) The license examinations are held by the Licensing Commission as formed by the Chamber.
- 2) The Licensing Commission is formed of three representatives from the Chamber, one representative each from the Ministry of Finance, the State Tax Office, the National Bank of Azerbaijan, a professor of economics, a representative of independent auditors, and a representative of the audit companies. The members of the Licensing Commission are announced at the beginning of the year by the chairman. All the seventeen members of the Examination Commission should have experience in audit, with no less than ten years’ experience in one of the related disciplines, such as accounting, financial control, economics, or law. Members of the Commission are paid salaries as appropriate.

Additionally, under Article 6 of the Law on Auditing Services (requirements demanded from the independent auditors), an independent auditor is required to have higher education in the field of accounting, finance, economic, and legal disciplines, and at least three years of working experience in their specialty. The independence of

the Chamber of Auditors is stipulated by the legislation. But there are points that cast doubt on the independence of this body. For example, under the law, municipalities are free to employ auditors. Unfortunately, conversations with the municipalities reveal that, in some cases, executive councils have auditors employed for them against the will of the latter. Analysis shows that the very auditor or the audit body he or she represents has, in some cases, personal relations with the executive officers, thus implying that an independent check of accuracy of financial accounts, statements, and reports of the entities is of formal nature, but mainly earns money for said party by formalizing such services. The lack of statements on the results the municipalities' audits on the official website¹⁵ of the Chamber of Auditors proves that their activity is merely of a formal character. In general, the reports of the chamber are wholly unavailable to the public, which has no external mode have access to them.

Another important matter is the improvement of the knowledge and skills of entities dealing with external audit, as well as to mandate professional associations with a view to applying up-to-date standards, as well as to arrange trainings for the auditors in order to improve audit standards.

According to the Chamber of Auditors, it developed 35 main and three auxiliary audit standards, as well as nine programs on field auditing between 1996 and 2005, in order to ensure professional activity¹⁶ (the wording, however, of the documents has not been placed on the website, and the documents have no printed version. Only the members of the chamber have access to them on an individual basis). The chamber also reports that its representatives regularly attend various international events focusing on an exchange of experience and perspectives of mutual cooperation, which are organized by international and regional audit and accounting structures. They also are taking measures to become full members of these institutions, in order to learn and apply international audit standards. Currently, the chamber is a cofounder and board member of the "Eurasia" International Regional Federation of Accountants and Auditors, a member of the European Federation of Accountants and Auditors (EFAA), and a full associate member of the International Federation of Accountants (IFAC).

Still, it is impossible to access official information on the issues of the training of its specialists. At the same time, unofficial contacts with members of the chamber revealed that they never participated in such trainings.

Given this situation, the activity of the Accounts Chamber seems to be more professional. Indeed, the management points out that it has not completely provided international audit standards thus far. Since there have been discussions on the development of national audit standards, which are in line with INTOSAI standards, and diverse variants of the standards have been designed, related activities still remain incomplete.

Regarding the international activity of the Chamber of Accounts, it is member of INTOSAI, EUROSAI, ASOSAI, ECOSAI, and some other international organizations of the supreme financial control in order to seek cooperation in the realization of parallel

control actions, exchange the appropriate directory materials, professional training and the improvement of professional skills of staff, etc. Over the past two years alone, its representatives have attended symposiums and conferences on themes such as “The Role of Audit in Enhancing Accountability in the State Sector,” “The Role and Significance of External Audit in Enhancing Government Accountability and Liability Before the Public,” and “Mutual Relations with Law Enforcement and Similar Agencies,” etc.

At the Chamber of Accounts, special attention is given to the exchange of foreign experiences in the field of supreme financial control. For example, with funding from INTOSAI, EUROSAL, ASOSAI, and ECOSAI, about 20 representatives of the Accounts Chamber and at their own expense, ten other representatives, have been through the following international courses and trainings: “Audit of Privatization,” “Audit of Sales,” “Audit of the Environment,” “Financial Audit,” and “Audit of Income” with a view to improving knowledge and professionalism.¹⁷

NOTES

- ¹ All legislative acts have been quoted from www.vescvv.com and www.e-qanun.az.
- ² *International Monetary Fund* “Guidelines to Ensure Transparency in the Budget and Tax System.” Published in Azeri, p. 65.
- ³ Report on the Activity of the Chamber of Accounts of the Republic of Azerbaijan in 2006 (2007) Baku, p. 47.
- ⁴ Website of the Accounts Chamber, available at <http://www.ach.gov.az>.
- ⁵ The Report on the Activity of the Chamber of Accounts of the Republic of Azerbaijan in 2006, *Baky* (2007) pp. 62–64.
- ⁶ The text of the resolution has been taken from <http://www.e-qanun.az>.
- ⁷ The text of the law has been taken from <http://www.e-qanun.az>.
- ⁸ The Law on Banks of the Republic of Azerbaijan was published in the issue 73 of the official gazette *Azerbaijan* on March 30, 2004.
- ⁹ Resolution available online: <http://www.vescc.com>.
- ¹⁰ Law available online: <http://www.e-qanun.az>.
- ¹¹ See: the text of the Resolution at <http://www.vescc.com>.
- ¹² Presently, the minimum salary in Azerbaijan is USD 58 (AZN 50 at the current rate of the National Bank).
- ¹³ Website of the Finance Ministry, available online: <http://www.maliyye.gov.az>
- ¹⁴ Report on the Activity of the Chamber of Accounts of the Republic of Azerbaijan in 2006, *Baky* (2007) p. 67.
- ¹⁵ See: the official website of the Auditors Chamber at <http://www.e-qanun.az>.

¹⁶ See: the official website of the Auditors Chamber at <http://www.e-qanun.az>

¹⁷ Report on the Activity of the Chamber of Accounts of the Republic of Azerbaijan in 2006, *Baku* (2007) pp. 68–69.

Audit Functions in Bosnia and Herzegovina

Brankica Lenić

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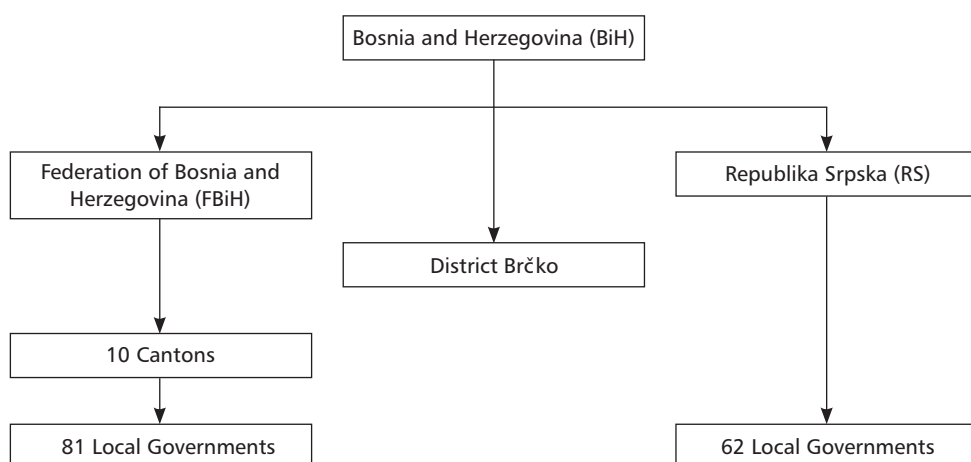
1. LEGAL FRAMEWORK

The Dayton Peace Agreement (DPA) in Bosnia and Herzegovina (BiH) was initialized in Dayton on November 21, 1995, and signed in Paris on December 14 of the same year. The DPA meant the end of the Balkan Wars, and BiH was divided into two entities: Republika Srpska (RS) and the Federation of Bosnia and Herzegovina (FBiH). The agreement on the borderline between the entities and related issues included arbitration for the area of Brčko. The Final Arbitration Award determined a special regime of administration in the Brčko area, as a unit of local self-governance under the sovereignty of BiH. The District of Brčko was established on March 8, 2000 by the enactment of the Statute on the District of Brčko.

Each entity has elements of a state with limited sovereignty, together making one country. The DPA-defined BiH consists of eleven annexes in which the basic principles of government systems have been determined, in addition to their civil and military issues. The competencies of the institutions on the level of BiH are limited.¹

With the DPA, BiH was constituted as one of the most complex system of government in Europe. Such a decentralized government was established to promote political stability and democratic participation in the decision-making processes. The complexity of the organizational structure in BiH complicates the reforms in all spheres and creates the need for additional efforts to introduce new practices and procedures at all levels of government. Follow-up on the implementation of the DPA was entrusted to the Office of the High Representative.

Figure 1.
Administrative Organization of BiH



The Peace Implementation Council in the Madrid Declaration, as of December 1998, recommended the creation of a Supreme Audit Institution to strengthen the Common Institutions, enhance the management of public finances, and ensure transparency.

The international community—through the World Bank, OSCE, USAID, OHR, and Swedish National Audit Office (SNAO)—joined their efforts to produce the legal framework and establish the Supreme Audit Offices in BiH. Three individual laws (the state and two entities), drafted by the World Bank and imposed by OHR, were passed between 1998 and 2000. All three drafts had identical provisions, though during parliamentary procedure some changes were adopted.

Furthermore, the World Bank's assistance was given to management in: organizational and internal structure, business and financial plan, concept materials, and guidelines for audit performance, including audit questionnaires and many other materials. The World Bank organized seminars on basic audit principles and supported office capacity building.

The Swedish National Audit Office (SNAO), funded by Swedish International Development Agency (SIDA), has embraced institutional cooperation and technical assistance, including support for the establishment of external, public audit institutions in Bosnia and Herzegovina (at all levels in BiH and its entities). The Memorandum of Understanding, as a support to capacity building on a long-term basis, was signed between SNAO and the BiH Audit Office; SNAO and the Audit Office of Sector in Republika Srpska; SNAO and the Audit Office of Federation of Bosnia and Herzegovina, in November 2000. Originally, the cooperation was based on a long-term basis (three to five years), though it has been extended until current times, and the SNAO will be providing education and technical assistance to the offices up to 2008.

The three audit laws were adopted and three offices were established in the period from 1999 to 2000. Pursuant to the provisions of the Audit Laws, the Audit Offices in BiH are the independent institutions in line with INTOSAI standards and defined as the expert bodies more linked to the Parliaments/Assemblies. As a model of establishing audit function in BiH, some EU Audit Laws have been used. In general, among all levels of governments in BiH, the Audit Offices are responsible for:

- a) Financial audit;
- b) Performance audit; and
- c) Other specific audit.

The auditors are obliged to follow the INTOSAI Code of Ethics for Auditors in Public Sector and to conduct their activities according to INTOSAI Auditing Standards. All offices are empowered to perform special audit on Parliament/Parliamentary Committee request.

The first audit reports in BiH demonstrated a serious lack of financial transparency and accountability in the public sector. Bearing in mind these results, as well as the Peace Implementation Council urging for measures to improve transparency in public budgets, the High Representative, in the exercise of his power, appointed an International Special Auditor for the FBiH, on March 2, 2001. Considering it was a similar situation in RS, the High Representative appointed the same person (Mrs. Dale Ellen Ralph) as the Special Auditor of RS. The Special Auditor was assigned a very wide mandate and the decisions of the appointment obliged all three Supreme Audit Offices to cooperate and support activities of Special Auditor. The reports are submitted to OHR and published with the recommendations of the Special Auditor, after approval. The mandates of the Special Auditors expired in April 2004.

In the period from 2005 to 2006 a new legal framework was adopted for three levels of the government. The intention was to improve the existing framework by the five years' experience of the three offices. The main changes were that the Auditor General and Deputy Auditor General for both entities should be appointed for a fixed non-renewable period of seven, instead of five years, as it was stipulated by the initial laws. Pursuant to the new laws, every year, the Audit Office shall carry out audit and shall provide an opinion related to the annual budget-execution report for the first level of budgetary users (Parliament, the president, the government, and respective ministries, extrabudgetary funds, and all public funds, institutes, and agencies), but the local governments of both entities are not necessarily covered by the audit of its budget-execution reports.

In compliance with the three audit laws, the Coordination Board of Audit Institutions was formed. The Auditor General on the state level acts as chairperson of the Coordination Board Committee. The most important functions of the Board are to harmonize audit standards and the auditors' code of ethics, audit quality, the responsibility for joint-institution auditing, and representing BiH in international organizations.

The Coordination Board agreed and supported the adoption of common documents and guidelines; the INTOSAI Code of Ethics for Public Sector Auditors (adopted in 2001) and the Joint Audit Manual (in 2003).

2. INSTITUTIONAL FRAMEWORK

2.1 Bosnia and Herzegovina

The Office for Auditing of the Financial Operations of the Institutions of BiH was established according to the Law on Auditing of Financial Operations of Institutions of

BiH, which was adopted in October 1999. The Law regulates the establishment of the Audit Office, its main functions, and the powers of Auditor General, such as gathering information, making reports, and manner and time of submitting of these reports, as well as its overall relationship toward the Parliamentary Assembly.

The state auditors were appointed by the Parliamentary Assembly in 2000. The international community welcomed this, seeing the appointment as a recognition of the BiH directive that all levels of the government shall be accountable to its citizens and taxpayers. By establishing independent audit, BiH was on its path to promoting transparent budgets, public accountability, and good governance, which is of the highest importance for the development of a market economy and democracy, as well as the establishment of conditions conducive to investment and business.

The Audit Office shall audit all institutions of Bosnia and Herzegovina as determined by the Constitution and the law, any government agency, any company in which the government has a share-holding, regardless of the size of that share-holding, and institutions or activities which receive government funds or funds provided by any external organization, either as a loan or grant, to Bosnia and Herzegovina. Since in BiH there were no subventions, grant or intergovernmental transfers from State Budget to the local governments, the Audit Office does not extend to the affairs of local budget institutions.

All audit reports are submitted to the audited subject for comments before their publication. The reports are presented and discussed at the sessions of the Parliament/Assembly on the level of the particular government. The Audit Office submits its reports to the BiH Parliamentary Assembly, the Council of Ministers, and the BiH Presidency, and the reports are accessible to the public online.²

The Presidency of BiH, based on the Audit Law (*Official Gazette of BiH*, No. 17/99), of the Rule Book of the Presidency of BiH (*Official Gazette of BiH*, Nos. 25/01 and 35/02), and the approval of the Parliamentary Assembly of BiH shall appoint the Auditor General. Based on the respective laws for Brcko District, FBiH, and RS, the Auditor General and Deputy Auditor General are appointed mostly under the same terms, and each of them shall:

- have an economic or legal university degree and experience in the area of accounting, audit, public finance, or public administration, of no less than 10 years;
- have not been found guilty in a court of law for committing a criminal offence, business crime, or acts incompatible with their duties;
- carry out the functions of the Audit Office in an independent manner in accordance with the INTOSAI auditing standards; and
- be a subject to the Law on Conflict of Interest in Governmental Institutions of Bosnia and Herzegovina (*Official Gazette BiH* No.16/02 and 12/04).

A vacancy for the posts of the Auditor General and Deputy Auditor General shall be published in the *Official Gazette* of BiH (BD, FBiH, and RS) and distributed in at least one daily newspaper throughout the territory of BiH (BD, FBiH, and RS).

The Auditor General, after consulting the Deputy Auditor General, shall determine the organization of the Audit Office by the Book of Regulations on Internal Organization and Systematization of Working Posts.

Staff of the Audit Office shall be appointed in accordance with the rules of service agreed upon between the Auditor General and the Council of Ministers, which must not be less beneficial than the ones provided for government servants of BiH. The Auditor General shall be appointed for a fixed, non-renewable period of five years and shall not be over age 60 at the appointment date. The Presidency may suspend the Auditor General or he/she can resign. The Auditor General's salary and allowances are prescribed in the regulations and are a direct charge to the budget.

The Deputies to the Auditor General are appointed by the Presidency acting in accordance with the advice of both Houses of the Parliamentary Assembly of Bosnia and Herzegovina.

Every year the Auditor General, after consulting the Deputy Auditor General, shall decide on the Audit Office's Annual Audit Plan for the following year, while also considering requests according to the respective laws of all levels of the government in BiH. The Audit Plan is submitted to the Parliament/Assembly committees responsible for audit, for their input.

In BiH, internal audit has been equalized with budget inspections for a long period already. Lately, the function of internal audit has been mentioned in many laws in BiH, and its function has been distinguished from the budget inspection. In spite of this, there is still a lack of clarity about the respective role of internal audit.

On the state level, internal control systems in some institutions are not sufficiently developed and defined as a set of procedures and measures which could provide the accuracy and regularity of financial transactions, their full accordance with the laws and regulations, or the protection of property. First of all, it seems that weaknesses in internal control are the result of an insufficient understanding of the importance of the establishment of internal control. Due to an inadequate internal control system, unauthorized expenditures, losses, and other errors occur frequently.

Local governments are required to establish internal control and to pass the rule-book on internal control procedures that regulates procedures, and ways for creating liabilities, maintaining bookkeeping records, and the spending of funds. The internal control operation should be based on the annual work plan and should be continuous throughout the year. The method of control should be prescribed by the Minister of Finance. The internal control unit shall be obliged to make a report at least once a year, and to submit it to the competent body.

The significant efforts of the BiH legislative authority to legalize the establishing of internal control for municipalities within BiH have been a result of the general recognition of significant problems across the state. Most municipalities have no formalized internal-control structure to ensure the proper spending of already insufficient public resources. Some BiH municipalities already have various internal controls in place though the existing internal control and do not possess the necessary characteristics of effective internal control. The main issues of local governments of internal control in BiH are:

- The municipality's objectives are not clear;
- No formalized internal-control structure;
- Lack of a healthy control environment;
- Lack of a clearly demonstrated commitment from senior management;
- Unmotivated staff;
- Undefined responsibilities in the work place in general;
- Risks not identified and assessed;
- Ineffective policies and procedures in key operational and financial areas;
- Disobedience in regard to legal obligations;
- Inaccurate information systems resulting in vague information on which decisions are based;
- Lack of effective monitoring and review of internal control;
- No effective internal audit in place.

In BiH, most municipalities do not have an internal audit function in place. This is understandable because the concept of internal audit of the public sector is still under development. The status and independence necessary for an internal audit service to function effectively need to be provided by law. The latest development in this field occurred in July 2007; the RS government adopted the Draft of the Law on Internal Audit of Public Sector in RS.

A coordinated and accepted approach at all levels of public service is necessary in order to develop an effective internal audit capacity in line with the best international practices.

2.2 District of Brčko (DB)

The District of Brčko is a unit of local self-governance under the sovereignty of BiH. The Law on Auditing of Financial Operations of Institutions of DB was adopted in July 2005 (*Official Gazette* DB, No. 21/05), shall provide for the establishment of an office for audit of financial operations of the district institutions.

The law states that there shall be one Auditor General and two deputies. The law also provides that the Brčko District Assembly shall appoint persons to these positions within three months from the date the law becomes effective. Unfortunately, more than a year was needed for the auditors to be selected.

The supervisor of DB, having seen no reasonable alternative after the long delays, imposed his authority on the process of appointing the Auditor General and the two deputies, and instructed the Committee for Appointments, Mandates and Immunity of the District Assembly to suspend any further activities in the selection process as of December 11, 2006. The supervisor decided to make the appointments himself to secure the effective operation of the district institutions and to protect its financial vitality. The positions were filled by the spring. It is expected that Brčko District will not be the only place in BiH where there has never been an audit of the government institutions.

2.3 The Federation of BiH

The Federation is composed of ten federal units (cantons). Each canton has its own Constitution, which is used as a basis for the cantonal legislation. Within its own competencies, the Federation makes its Constitution, laws and other regulations, all of which must be in accordance with the BiH Constitution. This Constitution determines exclusive competencies of the Federation, common competencies of the Federation and the cantons, which can be realized jointly or separately, or by the cantons, in which case it should be coordinated by the federal government, while the federal and cantonal governments make arrangements on these competencies on a permanent basis. Competencies that are not exclusively assigned to the federal government are given to the Cantons, and are defined as special competencies of cantons.

The Law on Audit of the Budget in FBiH was adopted in 1999 (*Official Gazette* FBiH No. 48/99). Based on the law, the Head Office for Auditing of the Financial Operation of the Institution of BiH was established as an independent institution in Sarajevo. Apart from the Head Office in the Federation, three Regional Audit Offices (Mostar, Tuzla, and Bihac) were established. In May 2006, a new Law on Auditing the Institution of FBiH was adopted (*Official Gazette of Federation of Bosnia and Herzegovina*, No. 22/06) which superseded the Law on Audit of the Budget in FBiH. The office

submits its reports to FBiH Parliament to the FBiH government, and FBiH president simultaneously.³

Regarding the complexity of the administrative structure of the FBiH, the law states: institutions directly financed from the budget adopted by the FBiH Parliament as the first level of budget users and the second level of users are funded via the first level of the budget users.

The office audits all institutions of the FBiH, including FBiH ministries, administrative organizations, and other bodies and institutions of the FBiH financed from the budget that was adopted by the Parliament of FBiH. The office mandate also covers audit for cantonal assemblies and governments, municipalities of FBiH, all budget institutions funded from the budget adopted by assemblies of cantonal and municipal councils, extrabudgetary funds, and any funds provided by international bodies or organizations to any institution or project in the FBiH, either as a loan or a grant to Bosnia and Herzegovina, as well as any company in which the state has a shareholding of 50 percent plus one or more shares. The office shall audit approximately 1,700 auditees, (in which 81 local governments have been included).

Table 1.
Audited Budget Users in FBiH, 2001–2006

Budget users	2001	2002	2003	2004	2005	2006
FBiH Institutions	26	33	40	26	24	27
Cantons and cantonal institutions	3	7	10	11	9	12
Local governments	12	18	9	1	0	1
Extrabudgetary funds	4	5	2	6	8	11
Public companies		2	2	10	14	15
Special audits	2	3	3	1	3	1
Total	47	68	66	55	58	67

Source: FBiH Audit Office Report for 2006.

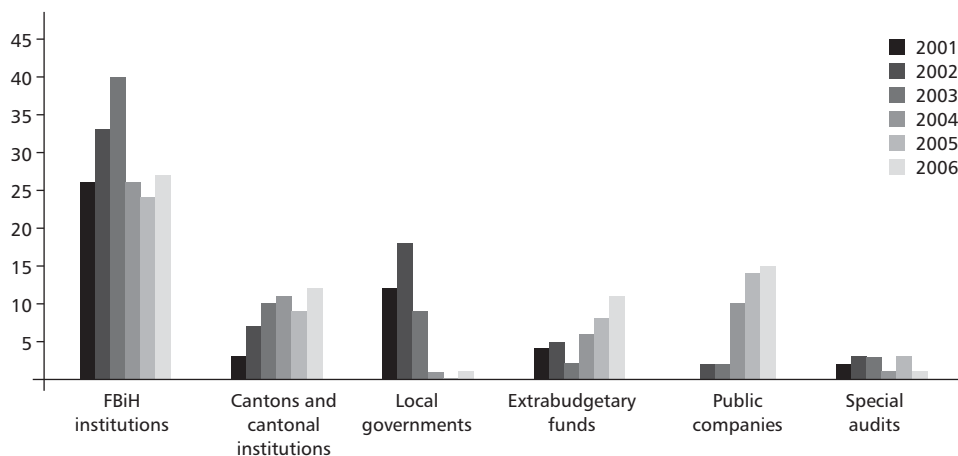
The Office of FBiH Auditor General, in the last few years, assessed a number of public companies owned by the entity, cantons and its governments, the FBiH government and the ministries, the Parliament, and a small number of local governments. Most audit assessments were negative and, thus, the office issued recommendations to put an end to discrepancies. Mainly, the reports asserted the following deficiencies:

- Budget rebalance was not adopted, although budget spending exceeded planned funds;

- Partially, current, and capital grants were transferred without following procedure and adopted criteria, while grants to individuals were mostly transferred without any criteria;
- Non-transparent budget spending occurs where some mayors violate his/her authorization;
- Absence of adequate internal control and audit;
- List of resources was not carried out in accordance with legislation;
- Non-compliance with procurement laws, the rulebooks, and the Decision on Procurement;
- Rulebooks on internal structure, labor and payroll in most local governments do not exist;
- A rulebook on accounting and accounting policies has not yet been adopted;
- Inventory lists do not match with accounting, as is stipulated by the rulebook on accounting of the FBiH budget;
- Incorrect calculation related to the depreciation of property.

Although significant discrepancies have been detected, the number of audited local governments has decreased in the last few years.

Figure 2.
Audited Budget Users in the FBiH, 2001–2006



Source: FBiH Audit Office Report for 2006.

The Audit Office staff comprise the following: the Auditor General, Deputy Auditor General, audit staff (auditors), and the administrative staff. The Auditor General is the head of the Audit Office, and responsible for the duties and powers given to the Audit Office under the law. The Auditor General has a Deputy Auditor General who assists in carrying out the duties of the Audit Office. Subject to the directions of the Auditor General, the Deputy Auditor General may assume all the functions, duties, and powers of the Auditor General.

The Auditor General and Deputy Auditors General are appointed by the Parliament of FBiH, upon the Proposal of the President of FBiH, and based on the ranking list of candidates prepared by the selection commission.

A vacancy for posts of the Auditor General and Deputy Auditor General shall be published in the *Official Gazette* of the FBiH and in at least one of the daily newspapers distributed throughout the territory of the FBiH. Other employees are appointed in accordance with the Internal Rulebook of Organization and Systematization Positions in the Audit Office.

In the FBiH, local governments are required to establish internal control and to apply the rulebook on internal control procedures. This was stipulated by FBiH Treasury Law and Law on FBiH Budget, though many municipalities still haven't respected this obligation. Internal control has been established in some of them, but remains limited in function.

2.4 REPUBLIKA SRPSKA

The Audit Office for the Republika Srpska Public Sector Auditing was established by the Law on the Republika Srpska Public Sector Auditing (*Official Gazette of Republika Srpska*, No. 18/99), which became effective on July 23, 1999.

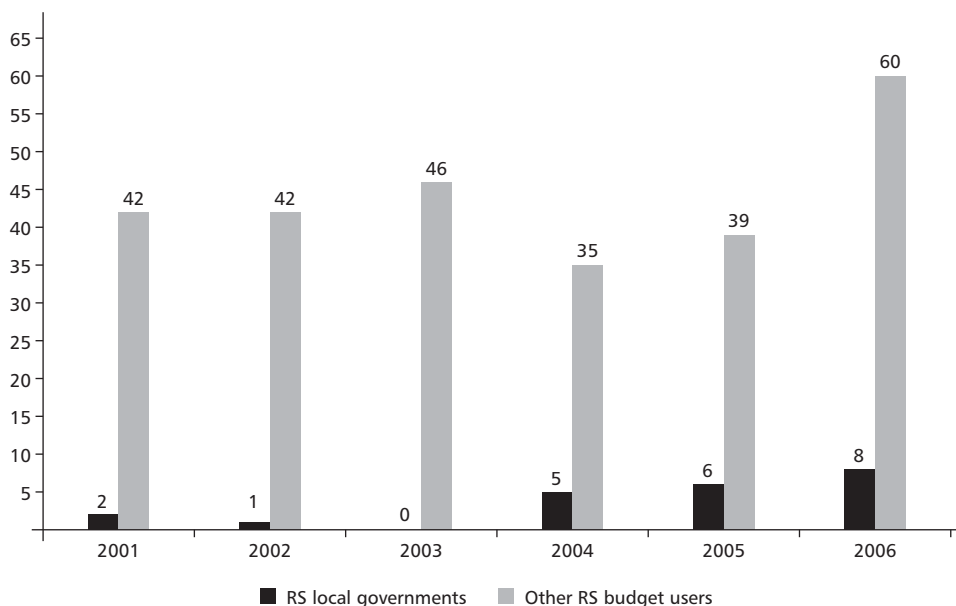
Their Audit Office is an independent institution auditing governments and its departments, municipalities, and a wide spectrum of other public institutions and organizations. The Audit Office submits reports to the RS National Assembly and the reports are also published online.⁴

The Audit Office audits all institutions of RS including: ministries, administrative organizations, and other bodies and institutions financed from the budget adopted by the Parliamentary Assembly and municipalities. The Audit Office mandate also covers audit of any funds provided by international bodies or organizations to any institution or project in the RS, either as a loan or a grant to Bosnia and Herzegovina, as well as any company in which the state has a share.

Since RS has a less complex administrative structure than FBiH, local governments are a bit more favored than in FBiH. The Audit Office of the RS Auditor General, thus far has given numerous negative assessments to LGs. Mainly, the reports show the same

lack of control as in the FBiH, since there is no adequate accounting system; accounting policies have not yet been adopted; the listing of resources has not been carried out in accordance to the rulebook on listing; and conflicts of interest occurred, in addition to budget excesses.

Figure 3.
Budgetary Users Audited in the RS from 2001 to 2006



Source: RS Audit Office Report for 2006.

From 2001 to May 2007, thirty-three financial audits of local governments were performed, and all of them undergoing a first-time audit. The Auditor General expressed 23 negative opinions and nine opinions were withheld. The management of audited local governments adopted a program on the evaluation for the removal of their perceived errors. It is very important that a municipality's management ensures proper follow-up actions on the recommendations which arose from the external audit reviews. In accordance with the timetable of the Auditor General, who stated that all local governments would be covered in the first audit by the end of 2007.

The Audit Office activities are conducted through the operations of two departments: the Auditing Department and Administrative Department. At the moment, they employ a staff of 34. There are 24 auditors in the Auditing Department: 12 senior auditors, one information technology auditor, and 11 junior auditors.

Upon the initiative of the president of the Republic, the National Assembly of Republika Srpska shall appoint Auditor General for the period of seven years.

The auditors are obliged to apply the INTOSAI Code of Ethics for Auditors in Public Sector, and to conduct their activities according to the INTOSAI Auditing Standards. The senior auditor is responsible for the team's work auditing. The teams shall audit clients that have been allocated to them in accordance with the annual auditing plan.

Pursuant to the Article 65 of the RS Budget System Law (*Official Gazette of the Republika Srpska*, No. 96/03), local governments should require the establishment of internal control and should apply the Rulebook on Internal Control Procedures. Many municipalities in the RS still haven't respected their obligation to the Budget System Law and have yet to establish the internal control.

3. RECOMMENDATIONS

BiH's external audit offices are relatively new institutions, but thanks to the international community, there is satisfactory legislation regarding it, and the staff is well educated. Because the external audit offices don't have the capacity to audit all local governments; in BiH, authorities have to make sufficient efforts to fully implement internal control and audit, and to make it understood as a mandatory requirement to meet the obligations of transparent governance as a service to the public.

To maintain the positive trend of the implementation audit function in BiH, it is essential that:

- Ministries of Finance enhance communication with local governments, especially after the adoption of new laws, to avoid dilemmas on the recording of budget transfers;
- To consider a greater increment of external audit staff, i.e., to ensure more budget users are covered by audit;
- To establish effective and efficient internal financial control in BiH, by reviewing the existing legislation and amending it as needed, to align with EU practice;
- To finalize the adoption of the internal audit legislation in BiH;
- To define the training needs for the period when the technical assistance of SNAO will no longer be available;
- Engage external auditors on performance audit development, already organizationally established, but poorly developed;
- The Coordination Board shall be further strengthened.

The external audit in the FBiH strengthens public-sector governance by increasing the transparency of transactions, and the accountability and efficiency of the administration as a whole.

The role of internal control increases with the decentralization process and the responsibilities granted to municipalities.

APPENDICES

Appendix 1: Legislation

State Level Legislation

General Framework Agreement for Peace in Bosnia and Herzegovina (Dayton Peace Agreement), December 14, 1995. <http://www.ohr.int>.

Law on BiH Treasury, *Official Gazette of BiH*, 27/00.

Law on Budget Execution of BiH Institutions, *Official Gazette of BiH*, 61/04.

Law on Civil Service in the Institutions of BiH, *Official Gazette of BiH*, 12/02, 19/02, 35/03, 04/04, 26/04, 37/04, 48/05, and 02/06.

Law on Financing of BiH Institutions, *Official Gazette of BiH*, 61/04.

Law on Indebtedness, Debt, and Guarantees of BiH, *Official Gazette of BiH*, 52/05.

Law on Supreme Audit of BiH Institutions, *Official Gazette of BiH*, 17/99.

Single Account Law, *Official Gazette of BiH*, 55/04.

Federation of BiH

FBiH Law on Treasury, *FBiH Official Gazette*, 58/02 and 19/03.

Law on Budget of Federation of BiH, *FBiH Official Gazette*, 19/06.

Law on Principles of Local Self-Governance, *FBiH Official Gazette*, 49/06.

Law on Public Investment, *FBiH Official Gazette*, 77/04.

Law on Supreme Audit of FBiH, *FBiH Official Gazette*, 22/06.

Law on the Civil Service in FBiH, *FBiH Official Gazette*, 29/03.

Rulebook on Financial Reporting and Annual Budget Execution, *FBiH Official Gazette*, 30/99.

Rulebook on Public Procurement, *FBiH Official Gazette*, 31/98.

Republika Srpska

Accounting Law, *RS Official Gazette*, 18/99 and 62/02.

Law on Budget System of RS, *RS Official Gazette*, 96/03, 14/04, 34/06, and 128/06.

Law on Civil Service in RS, *RS Official Gazette*, 61/02, 62/02, 38/03, 42/04, and 49/0.

Law on Local Self-Governance of RS, *RS Official Gazette*, 101/04.

Law on Supreme Audit of RS, *RS Official Gazette*, 18/99 and 39/03.

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Brčko District

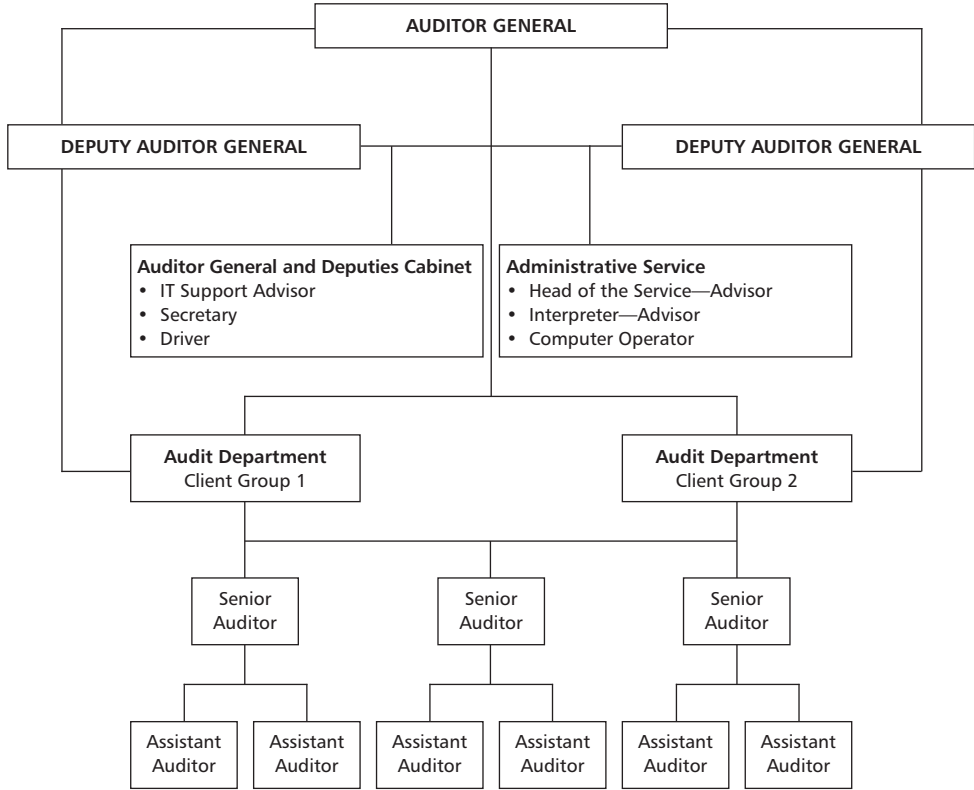
Law on BD Budget, *BD Official Gazette*, 16/01 and 21/05.

Law on Tax Administration, *BD Official Gazette*, 02/01, 02/03, 42/04, and 25/05.

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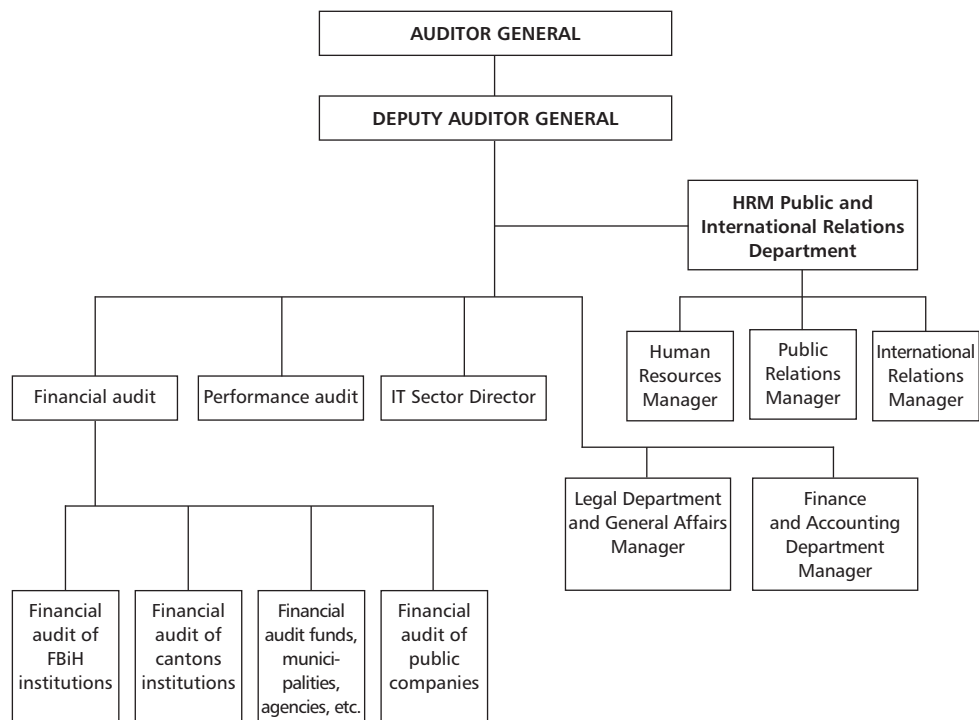
Appendix 2: BiH Audit Office Internal Structure

Figure A2.
BiH Audit Office Internal Structure



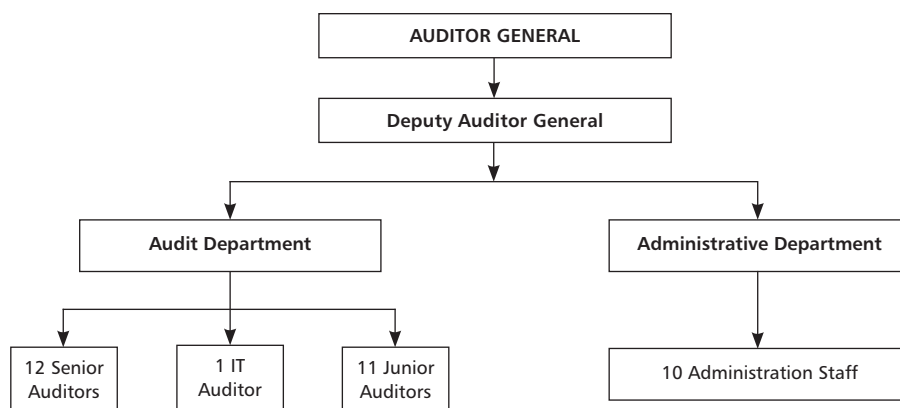
Appendix 3: FBiH Audit Office Internal Structure

Figure A3.
BiH Audit Office Internal Structure



Appendix 4: RS Audit Office Internal Structure

Figure A4.
RS Audit Office Internal Structure



NOTES

- ¹ Legislative authority: the Parliamentary Assembly of BiH (House of Representatives and House of Peoples), Executive authority: the Presidency of BiH and Council of Ministers of BiH, Judicial authority: the Constitutional Court of BiH, High Judicial, and Prosecutors Council of BiH, Court of Bosnia and Herzegovina, Public Prosecutors' Office of BiH, and Public Attorney's Office of BiH.
- ² Available online: <http://www.revizija.gov.ba>.
- ³ The reports are accessible to the public on <http://www.saifbih.ba>.
- ⁴ Available online: <http://www.gsr-rs.org>.

A Survey of the Existing System of Local Government Audit in Croatia

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1. INTRODUCTION

The major goal of the Survey of the Existing System of Local Government Audit in Croatia is to give an overview of the most important issues regarding the audit function in the Croatian local government system. In this survey, existing audit practices at the local level are investigated in the context of presenting the current situation, identifying needs, and making recommendations for changes in legislation and human resources development.

To carry out the preparation of *the Survey of the Existing System of Local Government Audit in Croatia*, we used a methodology consisting of three parts: (i) comprehensive desk research (legislation and human resources development analyses; SWOT analysis); (ii) case-study interviews (of representatives of several municipalities, towns, cities, and counties were interviewed to obtain a broader image on positive and negative aspects of the audit function at the local level), and (iii) recommendations for needed changes in legislation and human resources development.

In order to achieve our main goal, the current legal and institutional framework regarding the existing system of local government audit are also presented in the second part of this survey.

This survey will attempt to make a comprehensive clarification of the current human resources development in the area of existing audit practice at the local level. Human resource-development is presented in the third part of this survey.

The fourth part of the survey consists of a short SWOT analysis. The table includes a brief presentation of the major strengths, weaknesses, opportunities, and threats of the current legislative framework and human resources development concerning the audit system at the local level in Croatia. This SWOT analysis is the outcome of interviewing and presenting the experiences of several local government units (municipalities, towns, cities, and counties) on the subject of existing audit systems (legislation and human resources development). All of these case studies will be used to consider the basic constraints related to these preconditions, such as the preexisting knowledge gaps within local government units, to improve fiscal transparency and accountability.

The survey will also present conclusions regarding the improvement of audit function at the local government level with the main view towards the improvement of fiscal transparency and accountability.

2. LEGISLATION

What follows is an explanation of the legal framework for the internal and external audit systems of local government units; the role of the State Audit Office; and the role of local government units in the audit function; as well as the roles of other institutions incorporated in the audit system in the public sector of Croatia.

2.1 Legal Framework

The legislative framework that provides the current legislative basis for local governments' financial management consists of the following laws and other important documents:¹

- the Law on State Audit (*Official Gazette*, 70/93, 48/95, 105/99, 36/01, 44/01, and 49/03),
- the Law on the System of Internal Financial Control in the Public Sector (*Official Gazette*, 141/06),
- the Rulebook on the Internal Control of Budgetary Users (*Official Gazette*, 150/05),
- the Code of Professional Ethics of Internal Auditors in the Republic of Croatia,
- the draft Charter of Internal Auditors,
- the Handbook for Internal Auditors,
- the Handbook of Financial-Management System and Control,
- the Law on the State Budget (*Official Gazette*, 96/03),
- the Law on State Budget Execution for the Fiscal Year 2007 (*Official Gazette*, 137/06),
- the Law on the Organization and Domain of Central Government Administration Bodies (*Official Gazette*, 199/03, 30/04, 136/04, and 44/06),
- the Law on Financing Local and Regional Self-Government Units (*Official Gazette*, 117/93, 69/97, 33/00, 73/00, 127/00, 59/01, 107/01, 117/01, 150/02, 147/03, and 132/06),
- the Strategy for the Development of Public Internal Financial Controls (PIFC) in the Republic of Croatia.

2.1.1 Law on State Audit

The Law on State Audit regulates public-expenditures audit, financial report, and financial-transactions audit of the public sector, local and regional self-government units, public bodies that receive funds from the State Budget, public companies, municipal companies, and other public bodies.

The term “public expenditures” covers all current and capital expenditures that are financed with revenues from the State Budget, extrabudgetary funds, and local budgets.

An audit, by definition, is an examination of documents, reports, systems of internal control and internal audit, accountant and financial procedures, as well as many other reports to determine whether the presented financial reports show the accurate financial results of all financial activities in correlation with approved accounting standards and principles. An audit contains an evaluation of public activities’ effectiveness as well as an evaluation of program performance.

A financial-report audit is an annual obligatory activity for each fiscal year. The State Audit Office has the *Annual Audit Program* accepted by the Croatian Parliament.

After performing an audit, a certified public auditor prepares and signs an auditor report. This auditor report is then delivered to a legal representative of the public institution where the audit was performed.

2.1.2 Law on the System of Internal Financial Control in the Public Sector

The Law on the System of Internal Financial Control in the Public Sector regulates the system of internal financial control, which consists of financial management, control, and internal audit in the public sector. This law fortifies the methodology, standards, relations, and responsibilities of the Ministry of Finance and other bodies in carrying out the system of internal financial control in the public sector.

The Ministry of Finance is responsible for the coordination of all activities and development of the system of internal financial control in the public sector. The Department for Harmonization of Internal Audit and Financial Control is in charge of the coordination and harmonization of all activities.

The purpose of introducing internal financial control in the public sector is to improve financial management and decision-making to achieve the general goals and targets of budgetary users.

The system of internal financial control in the public sector consists of two major parts: (i) financial management and control, and (ii) internal audit.

The head of the local budgetary user (head of local government units, the head of a municipal company) is responsible for the establishment, development, and implementation of the system of internal financial control.

The Law on the System of Internal Financial Control in the Public Sector regulates concrete institutions in the public sector that have the duty to establish the system of internal financial control. Aside from central government ministries and institutions, local government units, municipal companies, and all other local budgetary users (institutions) in which employees' expenses and material expenses are financed from the local budget, have an obligation to establish the system of internal financial control.

There are three persons in charge of the establishment and development of financial management and control: the head of budgetary users, the head of financial management and control, and the coordinator of financial management and control.

The law proposes which staff of local government units could function as appropriate persons in the task of financial management and control. A Finance Department Chief at the county level, for instance, could function as the head of financial management and control. A City Finance Department Chief at the local level could also function as the head of financial management and control. Local government units or local budgetary users with but a small number of employees do not have an obligation to establish a 'head' of financial management and control. The coordinator of financial management and control could be nominated by the local government units, in response to the professional requests of the head of the local government unit. The head of the local government unit is in the position to ask for the establishment of an independent unit for financial management and control (if needed).

An internal audit is an important part of the system of internal financial control in the public sector. All budgetary users have an obligation to establish internal audit in one of the following ways: (i) independent unit for internal audit, (ii) joint unit for internal audit for multiple budgetary users (as agreed on by the Ministry of Finance), or (iii) in agreement with the Ministry, public institution, or local self-government unit (as agreed on by the Ministry of Finance).

The independent unit for internal audit is a very important unit of organization and belongs to the highest organizational level of budgetary users.

Another two possibilities regarding the establishment of an internal audit have been used in local government units which are not required to establish an independent internal audit unit. Because the Law on the System of Internal Financial Control in the Public Sector is new, it provides an opportunity to local government units to establish internal audit units during 2007, and at the latest by January 4, 2008. At the moment, it is impossible to give the total number of local government units that are going to decide on concrete way of establishing internal audit units. In practice, agreements with other authorities (contracting out), will also be used, and the form of the agreement will constitute an internal audit within the county for several small local government units. It is expected that the majority of small local government units will take the second possibility—contracting with the county. Several local government units will take the certified public internal auditors.

The head of an internal audit unit has the responsibility to prepare the annual report on the performed audit in accordance with the advice of the Central Harmonization Unit.

There is a person in charge of inspecting irregularities, and is appointed by the head of the budgetary user. The following persons are not eligible to be appointed as the person in charge of irregularities: the internal auditor, or any persons in charge of financial management and control. The law proposes appropriate choices in local government units for who can in charge of inspecting irregularities: a Chief of the Administrative Department for Legal Affairs or Secretary at the county level, or a Chief of the City Administrative Department for Legal Affairs at the local level.

The Law on the System of Internal Financial Control in the Public Sector, provided for the establishment of the Internal Audit Council, with the aim of strengthening the development and monitoring of internal financial control and internal audit. The Internal Audit Council is an advisory body to the Central Harmonization Unit.

The law sets the responsibilities of the Central Harmonization Unit. One of the most important tasks of the unit is to prepare a consolidated annual report on the system of internal financial control in the public sector. This consolidated annual report is discussed by the Internal Audit Council, approved by the Minister of Finance as well as the Government of the Republic of Croatia.

2.1.3 Rulebook on Internal Control of Budgetary Users

The Minister of Finance adopted the Rulebook on Internal Control of Budgetary Users,² which stipulates the conditions that an internal auditor must fulfill, the standards and methodology for internal audit, common criteria upon which budgetary users organize the internal audit function, and the coordination of work of budgetary users' internal audit.

The rulebook sets two criteria for the obligatory establishment of an internal audit unit for budgetary users. All budgetary users with more than 100 employees in central government bodies and 50 employees in local government units, or all budgetary users with annual total expenses exceeding HRK 30 million have an obligation to establish an internal audit unit.

The City of Zagreb, cities with more than 35,000 inhabitants, counties, county centers, and cities that finance decentralized functions in primary education, have an obligation to establish an internal audit unit.

According to current criteria, 9.4 percent of local government units, or 54 local government units (out of 576)³ are required to establish an internal audit unit. This means that the following local government units have an obligation for the establishment of such a unit:

- the city of Zagreb,
- 15 cities with more than 35,000 inhabitants,
- eight county centers (that are not included in the list of “big cities”),
- and 10 cities that finance decentralized functions in primary education (that are not included in the list of “big cities” or “county centers”).

The rulebook regulates cooperation with the State Audit Office and other bodies, as well as the authorities and tasks of the Ministry of Finance’s Central Harmonization Unit.

2.1.4 Code of Professional Ethics of Internal Auditors in the Republic of Croatia

The Code of Professional Ethics of Internal Auditors in the Republic of Croatia was adopted by the Minister of Finance on August 3, 2005, and is based on the principles and rules of the Code of Ethics of the Institute of Internal Auditors.

The code contains the principles and rules to which certified internal auditors must comply. Officials involved in the training for the certification of internal auditors, and other persons involved in internal-audit activities must also comply with the code. The adoption and implementation of the code promotes confidence in internal auditors and their work. Internal auditors must comply with the principles and rules of the code in order to ensure the independence, objectiveness, and integrity of their work while, at the same time, constantly improve their knowledge, with the aim of upgrading the quality of work.

The basic principles of professional ethics to which internal auditors must comply are as follows: integrity, independence, objectiveness, confidentiality, and the avoidance of conflicts of interest.

2.1.5 Draft Charter of Internal Auditors

The draft Charter of Internal Auditors was developed by the Central Harmonization Unit.

The Charter of Internal Auditors highlights a stronger functional independence of the relatively new profession of internal auditors in Croatia, and describes the relationship between internal auditors and the audited subject. The document contains the auditor’s competences, authorities, rights, and obligations which are confided to each audit office or audit unit, as well as to internal auditors. The heads of internal audit units, as well as

the heads of budgetary users, sign the Charter of Internal Auditors as a kind of agreement on mutual rights and obligations of internal auditors and audited units.

The document is one that can be adjusted to the needs of each individual budgetary user, while the Code of Ethics is unique for all internal auditors.

The Central Harmonization Unit keeps the register of the Charters of Internal Auditors. ORT ON THE WORK OF THE DEPARTMENT FOR HARMONISATION OF

2.1.6 Handbook for Internal Auditors

During 2005, the Handbook for Internal Auditors was prepared by both the employees of the Central Harmonization Unit and experts of the CARDS 2002 project,⁴ and it is been in use ever since. The Handbook for Internal Auditors prescribes the methodology for conducting an internal audit and was supplimented in the second half of 2005 by material on two additional areas related to risk assessment and audit of pre-accession funds (funds of the European Union).

2.1.7 Handbook of Financial Management System and Control

A Handbook of Financial Management System and Control was developed by the Central Harmonization Units. It describes in detail the individual actions and procedures which must be implemented in order to establish the appropriate system within each budgetary user. The Handbook of Financial Management System and Control is updated annually, aiming to address the potential problems that might arise during the establishment of the system.

2.1.8 Law on the State Budget

The Law on the State Budget stipulates the definition of an internal audit, and its task. It is prescribed that budgetary users at the central and local level must organize an internal audit unit, and that this falls within the responsibility of the head of the budgetary user. The law regulates the competences of the internal auditor, but it also stipulates that the Minister of Finance should prescribe by the Rulebook on International Control of Budgetary Users the conditions which an internal auditor must fulfill, the work methodology, and the common criteria based on which budgetary users should establish the internal audit.

Among other things, the Law on the State Budget regulates the competence of the head of the budgetary user which is responsible for the lawful, efficient, economical, and purposeful disposal of budgetary resources.

Also, the role of the *financial controller* and the *person accountable* is prescribed in this document. This is important for the establishment of internal controls.

2.1.9 Law on the State Budget Execution for the Fiscal Year 2007

The Law on the State Budget Execution for the Fiscal Year 2007 regulates revenues and expenses of the State Budget for the fiscal year 2007, budget execution, level of indebtedness, state guarantee, public-debt management, financial and non-financial assets management, and the duties and responsibilities of budgetary users, etc.

2.1.10 Law on the Organization and Domain of Central Government Administration Bodies

The Law on the Organization and Domain of Central Governmental Administration Bodies regulates the organization, authority, and tasks of central governmental administration bodies. The Law on the Organization and Domain of Central Government Administration Bodies was changed and supplemented in March 2004, when the Ministry of Finance became responsible for the development of public internal financial controls in line with international standards and the best of European practice. Thus, this task fell within the competence of the Central Harmonization Unit of the Ministry of Finance, and has subsequently become the primary task of this unit.

2.1.11 Law on Financing Local and Regional Self-government

The Law on Financing Local and Regional Self-government regulates revenue sources and the financing of responsibilities of local self-government units (municipalities, cities, and counties). This law strictly recommends fixed-purpose funds. The executive body in local self-government units is in charge of budget execution. The law regulates the audit function for usage of local revenues in two ways: (i) local self-government units (the representative body of local self-government unit) and (ii) the State Audit Office.

2.1.12 Strategy for the Development of Public Internal Financial Controls in the Republic of Croatia

The Government of the Republic of Croatia adopted the Strategy for the Development of Public Internal Financial Controls (PIFC) in the Republic of Croatia on June 15, 2005. The purpose of this strategic document on public internal financial control is

to highlight the key elements of the current situation, as well as the development of a strategy for the establishment of a comprehensive and efficient public internal financial control in Croatia.

The development strategy for the system of internal financial control, which is identical for both national resources and EU funds' resources, is of major importance for the accession of Croatia in the EU.⁵

The principles of internal financial control systems described in the strategy were implemented in the Law on the System of Internal Financial Control in the Public Sector.

The strategy describes the current situation in the field of the PIFC along with the overall control environment and legislative framework regulating this subject. Furthermore, it describes the system to be achieved, designating the goals to realize, and suggests a time framework for individual activities in PIFC development related to the accomplishment of the objectives within individual development stages, and also provides conclusions.

2.2 The Role of the State Audit Office in External Audit

It is obvious that the legislative framework allows and requires the State Audit Office to audit the financial affairs of local governments. The State Audit Office audits all public bodies and budgetary users where the majority of finances come from budget revenues. This is an *external audit system*.

The State Audit Office is responsible for the auditing of all financial affairs of local government and local budget institutions (local budgetary users). Auditing includes the use of state revenues, intergovernmental transfers, grants and aids, as well as the "own" revenues of local government units.

The state auditors audit local government units in correlation with the *Annual Audit Plan* of the State Audit Office. This means that, in practice, it is impossible that every local government unit be audited every fiscal year. Under the Annual Audit Plan the State Audit Office, every fiscal year concludes the audit of all counties (20), cities (126), and one-third of all municipalities. This means that the State Audit Office, every third year, audits all municipalities. As such, the State Audit Office audits the financial data in previous two years. An exception is made in the case of negative audit report. Under this circumstance, the State Audit Office performs an audit in the following year as well.

After completing the audit, the state auditors are in a position to prepare the *State Audit Report*. In the State Audit Report, particular consideration is given to issues of viability, efficiency, and legality of using public revenues by different local budget users. The State Audit Office audits and assesses the effectiveness of internal audit.

The state auditors report directly to the Croatian Parliament, and one copy of the State Audit Report is presented to the local budgetary users (the heads of local government units). Within a legally defined period, the head of the local budgetary user has an obligation to present explanations on the State Audit Report.

The State Audit Report is partially available to the general public after discussion in Croatian Parliament. This means that all State Audit Reports are publicly available on the website of the State Audit Office, as well as on the website of the Croatian Parliament.

Local media and civil society do not have automatic access to the State Audit Report. This means that the State Audit Office has no obligation to directly send the report to local media or civil society representatives.

2.3 The Role of Local Government Units in Internal Financial Control

The internal financial control is the duty of all budgetary users, including all local government units (municipalities, towns, cities, and counties), as well as all local public institutions and municipal companies where a majority of their revenue comes from the municipal budget.

The establishment of internal financial control is the responsibility of all local government units. Internal financial control at the local level consists of two separate parts: (i) financial management and control, and (ii) internal audit in local government units. The establishment of financial management and control should result in the improvement of financial management and decision-making to achieve the goals and targets set in the local strategic documents and local budget.

Internal auditors appointed by the head of the local government report to the head of the local government unit.

Responsibilities of internal auditors are connected with the improvement of financial management to achieve local goals and targets. The establishment of an internal audit would result in the improvement of the effectiveness of local-program performance (with financing by the local budget).

The role of local government units in internal financial control (internal financial management, control, and internal audit) is defined by the Law on the System of Internal Financial Control System in the Public Sector. An independent unit has to be established in every local government unit—*an independent unit for financial control and management and internal audit*.

Local government units are sometimes required to appoint external auditors to cover the financial affairs that are not scrutinized by the State Audit. Sometimes the heads of the local government units encounter a few dilemma regarding different financial issues (especially in the case of a new appointment). In this case, they do not have time

to wait for a regular audit under the Annual Audit Plan of the State Audit Office. They appoint external auditors to give them an objective report on financial issues in their local government units (or in their communal firm). There are several limitations that pertain to this particular issue. The most significant one is the financial limitation of small local government units' ability to hire qualified auditors.

Issues that pertain to external auditors include the legality and efficiency of the spending of revenues, and reports that are not publicly available. It is very rare that local government units request an external audit.

Municipal companies and other companies owned by the local government units are in the same position regarding the State Audit Office (external audit). Local public institutions (local budgetary users, including municipal companies) where a majority of finances come from budget revenues do not have an obligation to request additional external auditors.

2.4 The Role of the Central Harmonization Unit in the Establishment of Internal Audit and Financial Management and Control

The Central Harmonization Unit has the task of coordinating all the activities related to the establishment of an internal audit, and financial management/control units within budgetary users. It is, therefore, involved in the adoption of decrees regulating the internal organization of budgetary users. Namely, each draft decree of an individual body, prior to submission for approval to the government of Croatia, was discussed by the Central Harmonization Unit and an opinion upon it was issued.

A description and a list of activities for internal auditors and persons involved in financial management and control was developed (as were job descriptions of individual divisions, in order to ensure a relatively equal description of the tasks of those posts and divisions within all the acts of the budgetary users and other governmental bodies). In this way, an equal level in the normative regulation of internal audit and internal financial control can be achieved. It also ensures that the tasks of the PIFC or internal audit are well-established and described. Furthermore, it ensures that the internal audit unit is situated directly next to the head to which is accountable.

The Central Harmonization Unit regularly visits the heads of budgetary users and apprises them on the establishment of PIFC in Croatia, as well as on their further obligations in this area.

The internal organization and the required number of internal auditors within an internal audit unit are designated by the budgetary user through its own acts of internal organization, depending on the number of employees, business processes by which it accomplishes its goals, and the budgetary and other resources it has at its disposal.

The role of the Central Harmonization Unit in the establishment of internal audit and financial management and control at local level is crucial. In the near future, the Central Harmonization Unit and local government units are expected to continue joint work on the improvement of internal financial control at the local level of government.

3. HUMAN RESOURCES DEVELOPMENT

3.1 The Role of the Central Harmonization Unit in the Education of Internal Auditors and the Training of Persons Involved in Financial Management and Control

Together with the CARDS 2002 project experts, the training of internal auditors and persons involved in financial management and control was organized. The training of internal auditors is a continuous task of the Central Harmonization Unit, and one that is conducted by trained professionals. It is equally related to the training of persons involved in financial management and control.

For the purpose of conducting the trainings, and organizing the exam for the certification of internal auditors, the Minister of Finance promulgated, in August 2005, the *Program for the Professional Training and Examination for the Certification of Public Internal Auditors* and the *Instruction on Verification of Knowledge and Capacities and Examination for Certified Public Internal Auditors*, which prescribes the necessary training and modalities of achieving a professional certificate.

The education of internal auditors does not stop once someone has achieved the profession of certified internal auditor. The profession of internal auditor requires constant improvement and acquisition of new knowledge. Therefore, several study tours to the Netherlands, Finland, Latvia, and Slovenia were organized within the CARDS 2002 project, in order to familiarize auditors with the establishment, organization, and development of internal financial control systems within those countries.

In October 2005, *the first joint seminar of internal auditors* was organized in Umag. The seminar addressed three topics of particular concern related to strategic planning, compilation of reports on conducted audit, as well as the compilation of the annual report for the purpose of reporting to the Government of Croatia. The aim of the seminar was not only the acquisition of new knowledge, but also the formation of *a network of internal auditors*, as well as the development and strengthening of the internal-audit profession.

With the aim of establishing systems of internal financial controls (internal audit and financial management/control) within budgetary users, the Central Harmonization

Unit went to almost every ministry and other budgetary users to impart to the *heads of users* the importance and need to introduce the systems of internal financial control, and the benefits that such internal controls garner. The establishment of systems of internal financial control is not just a requirement of the European Union, but, above all, a necessity imposed for the purpose of efficient management and control of public resources.

3.2 Training of Internal Auditors and Acquisition of a Professional Certificate

The education of internal auditors began in April 2004, within the framework of the CARDS 2002 project. The lecturers were international experts who simultaneously established the program and methodology of education for the new profession of public internal auditors.

For the purpose of training for, and the organization of an exam for acquiring a professional internal auditor certificate, as well as for the implementation of the strategy for the development of PIFC, in August 2005, the Minister of Finance promulgated, on a proposal of the Central Harmonization Unit, the *Program for the Professional Training and Examination for the Certification of Public Internal Auditors* and the *Instruction on Verification of Knowledge and Capacities and Examination for Certified Public Internal Auditors*, which prescribe the training and modalities of achieving the professional certificate.

The above-mentioned instruction prescribes the modalities of the verification of knowledge, capacities, and the organization of the exam for certified public internal auditors, while the education, capacity verification, and examination for certified public internal auditors is conducted according the Program for the Professional Training and Examination for the Certification of Public Internal Auditors.

Certified public internal auditors are persons that fulfill the following criteria:

- University degree or higher,
- Prerequisites for the employment as a civil servant, and
- Professional certificate of the Minister of Finance to perform the activities of public internal audit, acquired through the program and procedures adopted by the Minister of Finance.

Officials who opt for the internal audit training and profession should append the approval of the head of the unit to their application, after which they are called in for an interview, in order to gauge their motivation, understanding, and attitude towards internal audit.

The training program is composed of both a theoretical and practical portion.

The theoretical portion consists of seven modules or basic subjects which pertain to the following areas:

- Best practice in public internal audit,
- Practice audit,
- Communication skills and interpersonal relations,
- Risk management and control,
- Advanced (complex) audit,
- Accountancy and finance, and
- Information technology in the service of audit and the basic elements of information-technology audit.

The training within each module lasts approximately five working days. The theoretical part of the training (mandatory) comprises a total of seven weeks. After the third module, the participants take a written exam regarding their knowledge and capacity for internal audit, in the form of an essay which also has to be compiled and presented. After the presentation of the written task (essay), the candidate is evaluated for their capacity and readiness for the performance of internal audit activities.

After their verification, the candidates are granted *the authorization—(Certificate I)* on which basis they are authorized to perform internal audit activities, in practice, with the mentorship of certified internal auditors. After receiving *Certificate I*, the participants may also continue their education within further modules and take an exam for certified internal auditors, but only after the seventh module. The final exam consists of five examination areas, or five separate sections. After passing the exam, the candidate is granted *the authorization—(Certificate II)* to perform the activities of internal audit which confirm that the candidates have mastered the theoretical skills acquired through seven modules.

Besides theoretical skills, it is necessary that internal auditors also acquire practical experience. The practical part of the education consists of at least two performed audits. The theoretical and practical parts of the education may last from 12 to 18 months, and are usually performed concurrently.

After the participants receive *Certificate I*, *Certificate II*, and perform at least two audits, they are granted the professional authorization for the performance of internal audit, and acquire the title of *certified internal auditor*. The professional authorization is granted by the Minister of Finance.

By the end of 2005, five training cycles had been held in which 100 internal auditors were involved. As many as 67 of them have passed the written exam, and 34 have achieved professional authorization by the Minister of Finance.

The Central Harmonization Unit keeps a *register of internal auditors* (as a relations database). The register contains data on each registered training participant or internal auditor. From the register, data on individual internal auditors can be retrieved, as well as specific data common to all internal auditors. In this way, the register fosters the establishment and maintenance of the internal auditors' network.

3.3 Mentorship of Internal Auditors

The procedure for the acquisition of the professional authorization for internal auditors was developed in cooperation with the Central Harmonization Unit and the CARDS 2002 project. The professional authorization for internal auditor certifies the acquired knowledge and skills, the capability of implementing international standards, and best practices in internal audit, as well as experience in internal audit.

Internal auditors who were granted the professional authorization by the Minister of Finance act as mentors to new participants who are trained as internal auditors within their internal-audit units. In the cases where the internal audit unit is established in-house but lacks a professionally authorized internal auditor, internal audits are performed under the mentorship of certified internal auditors (mentors) from the Central Harmonization Unit. For that job, the mentors are trained separately, and will also receive further training.

During 2005, internal audit experts have mentored a total of 24 pilot audits with persons involved in the process of education for internal auditors.

At the end of 2005, two employees of the Central Harmonization Unit were included in the mentorship. In the future, an even greater involvement of the Central Harmonization Unit employees in the mentorship program is anticipated.

3.4 Education of Persons Involved in Financial Management and Control

The system of financial management and control will be implemented in accordance with international standards for internal control. Therefore, one of the main tasks of the Central Harmonization Unit is the education of persons involved in financial management and control. During 2005, a total of 31 budgetary users (ministries, institutes, central offices of the Government of Croatia, and state administrative organizations) were included in the process of education.

For the managers of financial management and control, appointed as the persons responsible within budgetary users for the organization and implementation of those activities, a total of six workshops were held related to the establishment

of systems of financial management and control, as well as for risk assessment for managers.

At two workshops on the implementation of systems of financial management and control, there were a total of 44 budgetary users' representatives, while at two workshops organized as an advanced level of education, a total of 31 participants were present. Two two-day workshops were also held for financial management and control managers, related to *risk assessment*, where a total of 35 participants were present.

Two workshops at which 35 participants were present were held with the aim of introducing the elaboration of flow charts and audit traces to budgetary users.

Four workshops were held for financial controllers, i.e., persons involved in prior controls during 2005.

As many as 32 controllers participated in two two-day workshops, while two three-day workshops were attended by 34 participants.

The Central Harmonization Unit keeps a register on the workshop participants, financial management and control managers, as well as on financial controllers.

The monitoring of international internal control standards and best practices represents a need and responsibility of the Central Harmonization Unit. Therefore, international cooperation is foreseen in the form of participation in seminars and workshops related to the establishment of internal control systems.

3.5 Continuous Professional Improvement of Internal Auditors and Persons Involved in Financial Management and Control

The education of internal auditors does not terminate with the granting of the professional title of certified internal auditor. The profession of internal auditor requires constant improvement and acquisition of new knowledge. The same applies to persons involved in financial management and control. That is why the Central Harmonization Unit, together with the CARDS 2002 project, organized (at the end of 2005), study tours in the Netherlands, Finland, Latvia, and Slovenia, in order to study the establishment, organization, and development of internal financial control systems in those countries. The experience from those European countries will be used in the implementation of financial management and control in Croatia.

The Central Harmonization Unit organized the first seminar for public internal auditors (Umag, October 2005), which was composed of two segments: an introductory portion, on the current and future development of the internal audit profession in Croatia, and the work in workshops. The introductory portion informed internal auditors on the current situation, development, and future tasks in the field of internal audit. The workshops covered strategic planning, audit reports, and the annual reports of internal-audit units upon performed audits. The aim of the seminar was not only the

acquisition of new knowledge but also the development of the internal audit profession, and strengthening of the internal auditors' network.

The CARDS 2002 project heavily emphasized the establishment and sustainability of the internal auditors' network, which was later taken on as a task of the Central Harmonization Unit. In the future, those actions will be directed in cooperation with the Institute for Internal Audit, currently being established in Croatia.

Moreover, continuous education can be performed within other institutions, for instance: seminars and symposiums organized by the Croatian Community of Accountants and Financial Professionals, seminars organized by the Center of Excellence in Finance, Ljubljana, Slovenia, and conferences for the Central Harmonization Unit in the European Commission, and others as well.

3.6 The Role of the Internal Audit Council

The Internal Audit Council was established with the goal of strengthening the development and monitoring of internal financial control and internal audit. The Internal Audit Council is an advisory body to the Central Harmonization Unit.

The Internal Audit Council convenes at least two times a year for the purpose of:

- issuing an opinion on the consolidated, annual, internal audit report—prior to its submission to the Government of Croatia,
- giving advice upon problems which might arise within certain audits, individual internal auditors, or internal audit units, and
- advising on appointments or dismissals of internal audit unit managers.

The Internal Audit Council was appointed in December 2005, by a decision of the Government of Croatia.

The Minister of Finance is the president of the Internal Audit Council, while its members are ministers, heads of other institutions, and managers of certain internal audit units.

The first meeting of the Internal Audit Council was held in the beginning of 2006, when the consolidated *annual internal audit report* for 2005 was discussed prior to its submission to the Government of Croatia.

In accordance with the Law on the System of Internal Financial Control in the Public Sector, it is anticipated that the Internal Audit Council will address the overall system of internal financial control, not only the activities of internal audit.

4. SWOT ANALYSIS

Representatives of several municipalities, towns, cities, and counties were interviewed to obtain a broader image on the positive and negative aspects of the audit function at the local level.

Table 1.

SWOT Analysis Concerning the Audit System at the Local Level in Croatia

Strengths	Weaknesses
<ul style="list-style-type: none"> • Strengthening of financial transparency of LGUs • Constant control of business processes in LGUs • Preventive measures against possible risks • Implementation in all budgetary users (institutions financed from budget revenues) • Additional support for the heads of LGUs in providing financial advice about financial management in LGUs 	<ul style="list-style-type: none"> • Strong need to modify European legal practice regarding Croatian institutional and organizational practice • Additional resources are not planned in the local budget to cover additional costs in providing internal audit and financial management and control • Internal auditors and persons involved in financial management and control in LGUs will not be financially rewarded (they will not receive a higher salary)
Opportunities	Concerns
<ul style="list-style-type: none"> • Implementation of EU legal framework • Improvement of internal audit, financial management, and control in LGUs • Additional education and training in the area of internal audit, financial management, and control in LGUs • Continuous improvement in the system of financial management, control, and internal audit 	<ul style="list-style-type: none"> • Sanctions in the Law on the System of Internal Financial Control in the Public Sector are not prescribed • Increasing of the scope of work and responsibilities for internal auditors and persons involved in financial management and control in LGUs • Without the establishment of internal audit and financial management and control in LGUs, LGUs would not be able to apply for EU funds • Local budgetary users (local public institutions financed from the local budget) do not have a plan on how to establish internal audit and financial management and control in their own institutions • Small LGUs (all LGUs that do not have an obligation to establish internal audit and financial management/control in their own LGUs) do not have a plan on how to establish internal audit and financial management/control in their own institutions

5. CONCLUSIONS

On the basis of comprehensive analysis of legal and institutional framework regarding the existing system of local government audit; extensive clarification of current human resources development in the area of the existing audit practice at local level; and a brief SWOT analysis concerning the audit system at the local level, we can make the following conclusions and recommendations regarding improvement audit function at local level in Croatia, with main goal of the improvement of fiscal transparency and accountability at the local level:

1. The *local government audit system* is an important part of public sector reform in Croatia.

A crucial element of public sector reform is a reform of budgetary management practices to ensure that institutional arrangements and processes are put into place which allow policy-makers to make strategic policy choices based on an informed analysis of public expenditure issues, to transform those choices into actions, to ensure that budget expenditures are monitored and audited, and to make budgetary choices and results transparent to all elements of society. All that was mentioned above is important for local government units as well.

The majority of positive results in the area of the internal financial control system in Croatia are the result of joint work of the Ministry of Finance, Central Harmonization Unit, and the strong support of the European Union.⁶ Each budgetary user head, as well as the heads of LGUs, are responsible for internal control within his or her institution, and for internal control and auditing of all spending units within the competence of his or her institution.

Key elements of a strategy to improve local budget performance in Croatia include strengthening the planning of local budgets, strengthening internal financial management and control, and strengthening enforcement mechanisms through improved internal control and auditing.

2. It is obvious that a lot of progress in defining the *legal and institutional framework* concerning the system of local government audit has been achieved.

The Law on the System of Internal Financial Control in the Public Sector, and the Strategy for the Development of Public Internal Financial Controls, and Rulebook on Internal Control of Budgetary Users, prescribe that cooperation with the State Audit Office is necessary in order to establish a common approach to the most important audit issues, but, at the same time, keeping in mind the independence and autonomy of state and internal auditors.

As stipulated by the rulebook, internal auditors are obligated to cooperate with state auditors and provide them with all the information related to the content of terminated internal audits.

3. Each important public institution that has relevance to the system of local government audit in Croatia has defined tasks and responsibilities.

The State Audit Office has the necessary legal and organizational basis for its further development into an appropriate external audit body for all budgetary users (including local government units and municipal companies), but could be strengthened still more. In the area of the control of EU funds, it will be necessary to develop efficient monitoring, control, and audit mechanisms.

The State Audit Office produces an annual audit plan, that is then submitted to the Croatian Parliament for approval. It also has the authority to audit all entities receiving public funds. This includes ministries and agencies, local governments (counties, cities, and municipalities), extrabudgetary funds, central bank expenditures (not open-market operations), public enterprises, and the privatization office's expenditures (not the privatization process or outcomes). Parliament has the authority to change the plan or to direct the focal points of audits, but to date has yet to exercise this authority.

The State Audit Office consists of the headquarters of the State Audit Office (located in Zagreb), and the 20 county State Audit Offices. The Zagreb office (the headquarters) focuses its direct audit work on the central government. County State Audit Offices focus mainly on local government audits, though they may review regional activities of central government ministries.

The State Audit Office produces one consolidated annual report for Parliament of audit findings, including findings from local government audits. The county and municipal governments also receive an annual audit report, but only on those audits dealing with their own government's programs and expenditures. The State Audit Office has no prosecutorial authority. If the State Audit Office finds wrong-doing, they can only report it to the Parliament and government. The Ministry of Finance Financial Police and State Prosecutor's Office are responsible for investigation and prosecution. The Parliament can also hold hearings on findings.

The State Audit Office has broad authority to conduct financial and performance audits of the government. The State Audit Office staff view their core function as expenditure audits and, therefore, focus the audits mainly on financial and compliance issues, looking at the accuracy of financial records. The State Audit Office audit programs have thus far focused on adherence to current law and on the larger expenditures. The State Audit Office staff do report some problems with adherence

to the current budget as well as financial laws. The State Audit Office staff state that they generally report instances of noncompliance in audit reports.

One recommendation for improvement is: the State Audit Office should focus on financial management, program and performance audits as a medium-term goal. This is important for audit function at the central as well as at the local level.

Program evaluation is a deeper examination of specific programs to assess their effectiveness in achieving objectives and outcomes. Croatia does not have a mechanism for conducting deeper program evaluations. Program evaluations usually occur outside the normal budget cycle, though they are integrally linked to the budgets. The selection of which programs to perform deeper evaluations of usually arises in the context of budget preparation and enactment. If questions are raised about program accomplishments and effectiveness that cannot be answered quickly during budget debates, these programs should be selected for deeper analysis. Deeper evaluations identify programmatic weaknesses, suggest improvements and enhancements, and are an important tool for program management and budget allocation. The results of program evaluations are incorporated into the coming year's budget decisions.

The Central Harmonization Unit cooperates with numerous budgetary users, but also with other institutions, state-owned enterprises, and associations whose activities are linked to audit (commercial audit, state audit, and internal audit).

Cooperation is necessary in order to improve the system of internal financial control.

The joint education of internal and state auditors represents one of the most important forms of cooperation that will develop even further in the following years.

During 2005, the State Audit Office and internal auditors failed to establish viable cooperation. Despite this, important shifts were achieved in 2006, when the internal auditors of the Ministry of Finance were involved in the education of state auditors on the topic of audit of pre-accession fund resources.

The education program was organized within the framework of the twinning project of the State Audit Office and representatives of the state audit institution of the United Kingdom. A joint seminar for state audit representatives and internal auditors was organized by the Central Harmonization Unit in order to present the methodology and modalities of work of state and internal auditors. Such workshops and seminars will be held in the future with the aim of providing the best education and better relations between the two professions.

The Central Harmonization Unit will be involved in the activities of the Institute of Internal Auditors, which is currently being established in Croatia as a branch of the American Institute of Internal Auditors.

Cooperation has also been established with the Croatian Community of Accountants and Financial Professionals, i.e., the Internal Audit Section, which once a year convenes internal auditors from all the institutions for a joint seminar. Each instance of cooperation may help in the building and further development of a system of internal financial control.

In the area of internal financial control systems, the European Union requires from Croatia the development of general policies and a harmonized legal framework, which is currently being implemented. This means establishing or strengthening administrative capacities, including the functionally independent internal-audit units within government institutions, and training of the necessary staff. Moreover, it will be necessary to ensure that the Croatian administration is capable of providing an efficient and uniform protection of interest of the European Communities.

The role of the Croatian Parliament in the budget execution is crucial. In parliamentary systems, the legislature, and especially the Budget Committee, both play an important role in financial accountability and monitoring budget execution. In Croatia, however, the Parliament's effectiveness in monitoring budget execution is limited, due to: limited information made available to the Parliament; limited capacity to utilize information; and deference to the executive branch in financial matters. The Parliament receives two reports on budget execution each year, one mid-year, and one year-end. If the budget is out of balance during the year, theoretically, the Parliament could take direct action.

In practice, however, the Parliament follows the government's lead and, consequently, is not in a position to serve as an instrument of accountability. *Ex-post*, the Parliament receives the closing-accounts bill, submitted after the end of the fiscal year, and the report of the State Audit Office. But with limited analytical capacity of its own, there is little the Parliament can do except approve the closing-accounts bill. Overall, the Parliament needs to develop the capacity to participate more actively, and become an instrument for accountability. Currently, the low level of committee staffing means that the Parliament has effectively no independent expert advice supporting its involvement in the budget process. Neither the Budget Committee nor the Parliament has sufficient staff support to seriously analyze or engage the government on substantive policy issues in the budget process. The only interaction between the Committee and State Audit Office is the annual audit of the prior year submitted to the Parliament. The Budget Committee provides comments on the audit before it goes to Parliament; but it cannot request special audits by the State Audit Office or special studies. The Parliament needs better budget data and more detailed commentary to understand what is happening in each of the budgetary users, where changes are being proposed, and why.

To improve the role of the Parliament in budget execution, it is important to strengthen the staff of the Budget Committee with several professionals dedicated to public expenditure analysis; and to improve the quality and content of the annual budget submission to the Parliament to enable a fuller debate on the budget (making it more user-friendly).

The role of *representative bodies at the local level* in local budget execution is also important.

4. The list of recommendations for needed changes in *human resources development* includes the great need for additional efforts in the reorganization and capacity building for public internal financial control.
One of the priority tasks is raising the awareness of the heads of local government units and managers of municipal-owned companies of the need to establish and develop a system of internal financial control as a “tool” for the efficient management of public resources. Therefore, one of the main tasks of the Central Harmonization Unit in the upcoming period is to increase the awareness and responsibility of the highest-level officials in establishing this system, particularly in the segment of financial management and control.
5. A list of *limitations at the local level of government* in accomplishing audit functions includes: lack of much-needed human resources’ capacity in fulfilling the efficient financial management, control, and audit function. This is the most important factor that has been identified as a major obstacle to improving the current audit system at the local level.

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NOTES

- ¹ This part of the Survey is based on the Annual Report of the Ministry of Finance. Available online: <http://www.mfin.hr>.
- ² Local and regional self-government units belong to the group of budgetary users.
- ³ In Croatia, there exist 576 local government units: the city of Zagreb, 20 counties, 126 cities, and 429 municipalities.
- ⁴ CARDS 2002 project “Development of Internal Financial Control in Public Sector and Internal Audit.” The project was financed by the European Commission; the lead partner in the project was SOFRECO, France, in cooperation with Helm-Corporation Ltd, United Kingdom.
- ⁵ Prior to the submission for approval to the Croatian Government, the strategy received a positive opinion from the European Commission DG Budget, which is essential in the evaluation of the process of Croatia’s accession to the EU, linked to the answers in the Chapter 32 of the Questionnaire of the European Commission.
- ⁶ The CARDS 2002 and CARDS 2004 projects had authority and responsibility to provide support in the establishment and development of internal financial control systems in Croatia.

Local Government Audit Function Survey in Georgia

Revaz Kakulia

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1. BACKGROUND INFORMATION ON LOCAL SELF-GOVERNMENT REFORM IN THE REPUBLIC OF GEORGIA

Following the “Rose Revolution” in 2003, new parliamentary and pre-term presidential elections were held in the Republic of Georgia.

As initially expected, a comprehensive package of reforms were launched in Georgia, aiming to bring the country in line with the established European standards of democracy, rule of law, liberal market economy, effective governance, and transparent and accountable public administration.

The decentralization of governance and the establishment of a fully-fledged local self-government were declared as one of the top priorities by the new administration and the president. The proclamation of the aforesaid priority was further upheld by significant policy and legislative initiatives.

During 2004–2006, Georgian authorities undertook significant steps to strengthen the foundations of local democracy. Planning of the decentralization process and the respective legislative endorsements were indicative of due political willingness and determination. This process echoed the support of the Georgian population, as well as strong international assistance and expert recommendations, which were produced during the reform planning-process.

The following steps were undertaken by the government of Georgia through this period:

- On October 26, 2004, the Parliament of Georgia ratified the European Charter on Local Self-government (ECLS).

The ratification of the ECLS meant the recognition of the principles and objectives of the international document, and it was a clear indication of the state’s policy in the field of local government and decentralization. The ECLS became the keystone document for preparing Georgian decentralization strategy. The government of Georgia affirmed that it fully shares the principles and values envisaged through the ECLS and, therefore, the main objective of the governance-system decentralization is to develop the local self-governance system consistent with the standards of the European Charter.

- In December of 2005, the Parliament of Georgia passed the new Organic Law on Local Self-governance.

The ratification of the ECLS, and the ensuing political and legal circumstances accelerated the process of local self-government reform, and the development of the Georgian legislation matching the applicable requirements of the charter. The new legislative initiative—the Organic Law on Local Self-Governance—was intended to determine the legal, economic, and financial basis of the

implementation of local self-governance in Georgia. The law has defined the functions and competencies of local bodies, local expenditure, and revenue assignments; it created the foundations for municipal property and local fiscal politics conformable with the charter.

One of the major innovations of the Organic Law was the introduction of 69 consolidated self-government units (municipalities) instead of the previously existing 1,000 self-government units. These newly created, consolidated municipalities currently overlap with the administrative/territorial boundaries of former *rayons*.¹

In the course of fulfilling the charter's requirements and pursuant to the provisions of the Organic Law, the key laws on Local Self-government Property and on the Budgets of Local Self-government Unit were passed by the Parliament of Georgia, in March 2005 and May 2006, respectively. These laws created a financial and material basis for local self-governments' necessary for the fulfillment of their functions. *The Law on Budget of Local Self-government Unit has defined the principles of the formation of local self-government budget and rules for preparation, consideration, approval, execution, audit, supervision, accounting, evaluation, and control of the budget. It also defined the budgeting responsibilities of local self-government units.* While providing for budgetary and financial autonomy of municipalities, the law also incorporated the formula on equalization transfers. These novelties were the first steps towards the advancement of budgetary federalism in Georgia.

The adoption of the Law on Local Self-Government Property was another legislative initiative of utmost importance. This law determined property categories, property establishment rules, and proprietorship rights of self-governing bodies. It created the basis for the division of state and local property, and defined the property to be transferred to municipalities. The law classified the transferable property as basic and additional property, and provided the terms and mechanisms for their subsequent transfer into municipal ownership.

- In 2004–06, significant amendments were incorporated into the Tax Code of Georgia, the Law on Distribution of Tax, Non-tax and Capital Revenues among Budgets, and Law on Local Fees.

The property tax has been defined as a local tax, while 100 percent of revenues from the income tax were also allocated to local self-government budgets. The local tax on gambling has recently been transformed into a local fee, and along with other local duties, serves as a source for replenishing local budgets. The local administrations are entitled to introduce property taxes and local fees within the margins established by Georgian legislation. Meanwhile, the target

and equalization transfers/subsidies represent extensive revenue sources for local budgets.

In addition to the aforementioned legislative acts, several other self-government related laws are either being prepared or already deliberated in the Parliament of Georgia. Particularly, the Law on State Supervision over Activities of Local Authorities, which has already been passed by the Parliament of Georgia through a second hearing. This law defines two basic forms of state supervision: (1) legal supervision and (2) the expedience-motivated supervision over the implementation of delegated competences. It also defines transparent procedures of supervision over activities of local authorities which correspond to the principle of proportionality.

2. LEGISLATIVE FRAMEWORK ON AUDITING AND LOCAL SELF-GOVERNMENTS' FINANCIAL MANAGEMENT

Pursuant to the legislation already in force, local self-government units in Georgia are authorized to spend the revenues received from any legally envisaged sources independently, within the purview of their own competences and at their own discretion, except for the conditional transfer, special transfer, conditional subvention, or conditional subsidy.

Under the active Organic Law on Local Self-government, municipalities are empowered to independently define the direction of expenditures and the programs to be financed for the execution of own authorities (exclusive and voluntary). With respect to the delegated authorities, the expedience-motivated and administrative supervision over the law-compliant implementation of such authorities are to be defined by the Law on State Supervision over Activities of Local Authorities, as noted above.

The Organic Law (Article 57) itself provides for two forms of financial control of local self-governments' financial management: (1) audit and (2) financial inspection.

2.1 Audit (External Audit)

Audit is defined as an inspection of the financial documentation of local self-government bodies, which may be conducted by an *invited (professional) auditor* not more than once a year, based on a written demand of one-third of the elected local council (*Sakrebulo*) members.

The law stipulates that the audit report and conclusion shall be submitted to the chairman of local council (*Sakrebulo*), who will then present it to the *Sakrebulo*. At the same time, the invited auditor is obliged to send a report and conclusion to the Georgia

Chamber of Control (GCC), which, for the purposes of this report, might be considered as an external public auditor, as opposed to the *external invited auditor* represented by a private, independent auditor, or audit firm. The audit report is to be subsequently publicized as required by the Article 57 of the Organic Law.

Based on the Law on Chamber of Control,² the GCC represents the supreme body of the state's financial-economic control accountable only to the Parliament of Georgia; as an independent body defined under the Constitution of Georgia, it supervises the application of state funds and other material resources and controls the legality, purposefulness, and effectiveness of the utilization of such funds/resources. In a broader sense, the Chamber of Control represents the external (public) auditor, which is given a certain authority to perform value-for-money audits. In the local self-governance context, the GCC basically audits targeted programs and earmarked (conditional) transfers.

In accordance to the Law of Georgia on Budget of Local Self-government Unit (Article 24), the Chamber of Control is in charge of carrying out the control over the legitimate and purposeful utilization of conditional (targeted) funds as well as resources transferred to municipalities for the implementation of delegated (non-exclusive) functions that are allocated from the State Budget of Georgia and the Budget of Autonomous Republic. Consequently, the GCC's scrutiny is limited to conditional state transfers and funds allocated to local self-governments for implementing the delegated authorities.

The Chamber of Control is a member of INTOSAI and EUROSAL. It determines its own audit plan each year, yet also audits entities selected by Parliament or the president. The GCC is obliged by law to submit the report on its activities once per year to the Parliament of Georgia, which, upon the consideration of the report, adopts the pertinent resolution. The report is published by the official publishing body.

2.2 Financial Inspection (Internal Audit)

Different from (external) audit, financial inspection is conducted by the local self-government council's (*Sakrebulo*) Financial Commission that follows the funds' utilization and determines the legality, expediency, and effectiveness of the reception and utilization of the funds.

Financial revision—as an *ex-post* form of control—implies identification of compliance with the law of the documentation on incurred expenses, financial accounting and reporting, relevant decisions made by an authorized person (body), financial standards set by the legislation, and it also determines the economic expediency and effectiveness of the utilization of funds.

The Law on Budget of Local Self-government Units (Article 24) provides in detail for the control, audit, estimation, as well as approval of the fulfillment report of local self-government unit's (municipal) budget. Based on the respective article, local self-

government councils are expected to adopt the procedures on *internal audit* with respect to the operations related to revenues and expenditures—pursuant to the legislative acts issued jointly by the Ministry of Finance of Georgia (MoF)³ and the Chamber of Control, as well as in accordance to the established international standards.⁴

The *internal audit* is carried out under the direct supervision of the local self-government representative body (*Sakrebulo*). It has a special competence to set control over the execution of a local self-government unit's budget. At least once in a quarter, the *Sakrebulo* carries out an evaluation of the execution of approved budget programs, whilst a report on the execution of the municipal budget must be prepared by executive body of local self-government unit, and no later than two months after the end of the budget year, submit it to the local council. The law requires that the local budget execution report should be published for the purposes of public hearings no later than one month before the review of the execution report. The legislator further specifies that a local self-government unit budget-execution report should include:

- a) Revenue collection as per its type. The data should include any indication of surpluses or shortfalls compared to the planned amounts;
- b) Analysis of the results of the budget program implementation versus the goals and tasks set by the program; shortcomings in planning revealed during the process of implementation of these programs;
- c) Report on the use of reserve funds;
- d) Other data as requested by the local self-government representative body.

Based on the local self-government unit's budget-execution report, local council reviews and evaluates the fulfillment of the budget and provides recommendations for the next budget year.

The auditory conclusion on local budget and the fulfillment report are submitted to the Chamber of Control, whilst the respective documents represent public information and should be made accessible to the public in conformity to the established rule.

2.3 Audit of Municipal Companies

The Chamber of Control is authorized to carry out an audit of municipal companies and of the companies where the municipalities own shares, but only to the extent that the state budgetary funds are utilized or the delegated functions are exercised.

Typically, the management of those companies is accountable to the founder of company—the municipal authorities. In general, the form of this accountability is to be defined by the regulation of the local council and the pertinent regulation of the company in accordance with the Law on Entrepreneurial Activities. The respective commission

of the local council and/or a special unit at the local executive office is empowered to carry out an audit. The latter may do so, if the local council resolves that the ongoing control over the management of a municipal company should be exercised by the relevant unit/service of the local executive body. The Organic Law on Local Self-governance provides that the local council and, accordingly, its commissions, are authorized to require reports from local executives as well as from the companies that are established with their share participation. This procedure is not regulated, though, by the existing legislation in a fully consistent manner. There are also the cases when the companies established by municipalities participate in tenders (public procurement) where state funds are involved; on such occasions, a municipal company that is allocated the state (as opposed to municipal) funds can be audited by the Chamber of Control, as well as monitored by the State Agency on Public Procurement⁵ according to the procedures envisaged by the pertinent legal norms.

External audit may also be invited by the local council and/or at the initiative of a municipal company itself.

3. GENERAL REVIEW OF THE GEORGIAN AUDIT SYSTEM

3.1 Key Characteristics

Formally, the above-described audit system resembles a dual system of politically elected auditors and professional auditors. The responsibility for the internal audit (financial inspection) rests with the political level, as the politically elected members of local councils are responsible for its fulfillment. These politically elected auditors—the *Sakrebulo's* financial commission in this particular case—like other local council commissions, are entitled to engage professional assistance/expertise in carrying out their tasks, including financial inspection. Upon consideration of the local council's chairman and based on the rule defined by local council's regulations, they may invite/hire permanently, or on a provisional basis, other persons/experts to work with the council's commission.

The legislation also sets forth general grounds for carrying out external audit, which might be initiated at the request of a local council, though no more than once per year. External auditors have not been employed by local councils thus far. There are several reasons for this; it was due in part to the fact that newly-elected local representative bodies generally experienced difficulties adapting to the new local government system and requirements set by the Organic Law, while the budgets of self-governing units happened to be adopted late. In addition, there are still relatively scarce financial resources in most localities as well as a shortage of well-trained local auditors specialized in local government.

Generally, the (professional) auditors' activities are regulated by the Law on Auditing Activity.⁶ Auditing activity includes auditory inspection (audit), rendering auditing services, organizational, and methodological support of auditing.

Audit inspection (audit) can be carried out by auditors and auditing firms with the purpose of checking compliance of the entrepreneurial activity of the economic entity, its public recording and accounting, the authenticity and integrity of its taxation-related financial-economic, and operational activity, as well as of the statutory requirements with the legislation and normatives in force. The legislation distinguishes mandatory audit from a discretionary audit, which may take place upon the initiative of the economic entity, based on the respective contract. Such auditing also might be invited by law-enforcement bodies in conformity with the active legislation.

Auditory service includes provision of accounting services, expertise, and consultations in finances, taxation, and other related fields of business legislation.

As provided by the law, the auditing activity is carried out independently from the financial control exercised over the economic entities by specially authorized state bodies.

3.2 State Regulation of Auditing Activities

3.2.1 Scope of State Regulation

In general terms, the state regulation of audit activity involves the following: a) legislative framework for audit activity; b) attestation of auditors; c) licensing of audit activity.

For the purposes of exercising the state functions in regulating the auditing activities, a special Auditing Activity Council (AAC) has been created by the Parliament of Georgia. The competencies and functions of this council are defined by the respective regulation, then approved by the supreme legislative body of Georgia. The competencies of the council includes *inter alia*:

- elaboration of the standards and methodological recommendations for conducting the audit;
- elaboration and approval of the qualification requirements for attestation of auditors;
- elaboration and approval of the instruction on licensing the auditing activity;
- creation of the system for training/re-training the auditors' cadres, raising their qualification, carrying out attestation of auditors, and licensing the auditing activity;
- creation of unified state registers for auditors and auditing firms;

- control of the auditors' performance quality, revealing and providing feedback on the violation of the legislation in force, of auditing standards, requirements of the code of auditors ethics, respective regulations and normative acts;
- receiving and analyzing the annual reports submitted by individual auditors and auditing firms.

The law envisages the possibility of delegating certain matters under the competence of the council to the civil unions of auditors' self-governance.

Furthermore, the law specifies that the auditor is to be considered a natural (physical) person who holds auditors' qualification certificates issued by the Audit Activity Council at the Parliament of Georgia. Pursuant to the established norm, the auditor can perform audit independently—based on the license and/or through an audit company. As for the audit companies, they are considered enterprises, which possess licenses allowing them to perform audits throughout Georgia, and with the sole statutory objective of performing audit activity. An audit company or its affiliation is granted the right to conduct audit activity if at least one auditor is employed by that company.

In our interview with the deputy chair of the AAC, Mr. Elguja Aphridonidze,⁷ he mentioned that prior to July 2005, about 600 auditors were authorized by the AAC, from which 500 were authorized directly by the Audit Council, while others were authorized under an arrangement with the Georgian Federation of Professional Accountants and Auditors (GFPAA). He also outlined the controversial changes regarding the abolishment of licensing requirements—introduced through new legislative initiatives—reviewed later in this report.

3.2.2 Attestation and Licensing of Auditors

The Auditing Activity Council is in charge of organizing attestations (determination of qualification level) of auditors. Natural persons eligible for attestation can be persons with high or special economic background or with a juridical education background with at least five years' experience of working as auditors, a specialist in an audit company, accountant, scholar, or teacher of economics. Natural persons are granted the qualification certificate for the terms not exceeding five years after passing the qualification exams. Specific requirements for attestation are determined by provisions respectively approved by the AAC.

Auditors and audit companies have the right to perform audit throughout the territory of Georgia only after receiving the license. Independent licenses are issued for: (a) bank accounts; (b) audit of insurance companies; (c) audit of exchanges, special state funds, and investment institutions; (d) general audit (audit of other economic entities). A single audit company can obtain a license for audit activity in one or more areas.

However, there is *no special license* for conducting local self-government audit, and this might be an issue for further discussion and consideration.

Specific requirements for licensing audit were determined by Special Resolution No. 2 on Approving the Rule on Licensing the Auditing Activity, which was adopted by the AAC on November 6, 2002.⁸

3.2.3 Rules for Conducting Audit Activity

In conformity to the Law on Auditors Activity, an audit is performed through the agreement concluded between the auditor (auditor company) and the client. Audit in the form of consultancy is to be performed on the basis of a written request of the client to the auditor.

The agreement between the auditor and client is required to include the subject of audit and terms of performance, scope of audit service, service fee and payment terms, the responsibility of parties, etc. The subject of the agreement, and the terms and conditions, shall be considered highly confidential.

Economic entities are granted the right to select the auditor (or audit company) according to their preference. The auditor is entitled by the law to be independent from their clients, as well as from any third party, including government bodies, as well as from the owners of the audit company where they are employed. The client is required to provide the auditor with necessary conditions to perform the audit.

3.2.4 Rights and Obligations of Parties in Audit Activity

Auditors, according to the active legislation, are entitled to:

- Determine independently the forms and methods of audit;
- Receive all necessary information from the client, or any third party relating to the subject of audit. Third parties possessing such documents are expected to provide the auditor with such documents at the submission of the request confirmed by the client;
- Receive all necessary explanation verbally or in writing from managers and employees of the client regarding the subject of the audit;
- Perform due diligence of the documents reflecting client business activity, cash, valuables, securities, etc.;
- Invite on a contract basis, specialists of various fields to participate in the inspection.

As for obligations, auditors pursuant to the established legal norms are required to:

- In performing the audit, observe and strictly adhere the legislation of Georgia, audit standards active in Georgia, requirements of the code of audit ethics, and norms and regulations;
- Provide high-quality audit service, check the accounting and reporting situation upon the request of client, their authenticity, accuracy, and compliance with the legislation in force, as well as the already-established regulations;
- Inform the client, or their authorized representatives, as to the weaknesses revealed during the audit of accounting and reporting statements;
- Keep confidential all the information made available for them during the audit, except in the cases envisaged by the legislation.

Those individual auditors and audit firms which fail to fulfill their responsibilities, bear the material and/or other type of liability in conformity to the legislation in force, and the concluded contract with the client. The existing rules also specify that auditors' material (property) liability should not exceed the amount of actual damage caused to the client.⁹ Any dispute between the auditor (audit company) and client organization is to be settled by the court under the active legislation.

The law also sets forth the obligations for the economic units (their managers) the activity of which is a subject of mandatory auditing inspection; namely, those entities are required to inform the tax authorities prior to December 31 of the reporting year regarding conclusion of the contract on inviting an auditor to inspect the organization. Additionally, the auditor's report should be submitted to the tax authorities along with the annual financial statements.

The managers of such economic entities are bound by legislation to provide the auditor with all necessary explanation, verbally or in writing, regarding the subject of the audit, and provide the auditor with favorable conditions to conduct the audit. Similarly, they are expected to provide quick resolution to the problems revealed during the audit inspection.

The list of the economic entities that are subject to mandatory auditing inspection is approved annually by the Ministry of Finance of Georgia.

3.2.5 Conflict of Interests

Under the legislation of Georgia, professional auditors are required to have special expertise, as described above. At the same time, there are strict formal rules in respect to their competence to perform audit. The following are restricted from performing the audit:

- Auditors being in close relations (close relatives) with any managers of client organization;
- Auditors having property (material) interest with the client organization;
- Auditors being employees, owners, founders, or managers of the client organization;
- Auditors being employees or co-owners of the daughter company of the client, its affiliate, or representation office.

3.2.6 Grounds for Terminating Auditing License

The Auditing Activity Council (AAC) at the Parliament of Georgia is authorized to terminate the licenses issued to auditors in cases envisaged by the Law on Auditing Activities,¹⁰ namely, it is entitled to do so in the following cases:

- once it is repeatedly revealed that an audit was performed below the required standard;
- in the case of a deliberate infringement of active legislation, audit standards, requirements of code of auditors, and of the established norms and regulations;
- should it become evident that an auditor had submitted false information to obtain their license;
- an auditor undertakes activity not envisaged by the granted license.

3.3 Audit Self-governance Bodies and the Scope of their Activities

As already mentioned, the Law on Auditing Activities envisages the possibility of delegating certain matters under the competence of the Auditing Activity Council (AAC) to the civil unions of auditors' self-governance.

The Georgian Federation of Professional Accountants and Auditors (GFPAA) stands out in this respect among such unions. The federation was formed as a result of merger of the Georgia Club of Accountants and the Georgia Association of Accountants. The GFPAA was officially registered on May 5, 1998, as a union (association) in conformity to the Civil Code of Georgia.

The GFPAA became the first self-regulated professional organization in Georgia. On February 5, 1999, the Parliament of Georgia passed the Law on Regulation of Accounting and Reporting. The law recognizes the "independent professional organizations of accountants" and specifies that they are eligible to: (a) develop interpretations of the International Accounting Standards (IAS); (b) prepare accounting and reporting

recommendations on those accounting issues that are not regulated by the IAS; (c) upgrade qualifications of accountants and certify professional accountants.

Since 2000, GFPAA has been a full member of International Federation of Accountants (IFAC). Presently, it counts more than 2,000 members, out of which 469 are full members, and 12 (auditing firms) corporate members.¹¹ Only certified accountants are entitled to the designation of full member. During the period of 1997–2005, at the initiative of the federation, and with its direct participation, the following was accomplished:

- The Law on the Regulation of Accounting and Reporting was adopted;¹²
- International Accounting Standards (IASs) were adopted intact as Georgia's own national standards;
- International Accounting Standards (IASs), International Standards on Auditing (ISA), along with their practical guidelines, were periodically translated and published;
- Professional self-regulation emerged;
- The Institute of Professional Accountants (training center) was established;
- A certification system to train specialists, continued-education, and professional-certification programs were developed.¹³

The GFPAA is actively involved in introducing, harmonizing, and cultivating international standards of accounting and auditing, in improving the quality of auditing in general, and implementing standard international practices amongst audit-activity institutions. It is actively engaged in training and retraining specialists to deepen their theoretical and practical knowledge, and also provides for their professional certification. The federation's major services include: developing methodological and practical manuals, guidelines, training, certifications, and consultations in the fields of financial reporting and accounting, managerial accounting, management, financial analyses, auditing, professional certification, as well as providing various training courses. Additionally, as already noted, the GFPAA was the initiator of the establishment of the IAS and ISA standards in Georgia, which are currently used unmodified. It is also the only union in Georgia to be able to choose the ACCA (the Association of Chartered Certified Accountants) program and start translating and developing it, as it is based on these standards. Since 2000, the GFPAA has been using these materials in the certification process. It is also worth mentioning that, according to the federation's official website, it has retrained more than 8,000 specialists throughout Georgia.

Based on Resolution No. 6, adopted by the collegium of the AAC, the federation was formally delegated the function of preparing an English-Georgian edition on International Auditing Standards in cooperation with the AAC.

3.4 Compliance with International Standards

At present, Georgia is one of the first among former Soviet countries where the use of the International Standards is legally mandated. In 2005, the Special Commission on Accounting Standards at the Parliament of Georgia approved the resolution on Introducing the International Standards of Financial Accounting, Bookkeeping, and of their respective interpretations. The resolution was enacted in April 2005.

Georgian auditors and audit firms also are obliged to use the International Standards on Auditing, as promulgated by the International Auditing and Assurance Standards Board (IAASB.). The Audit Council states that the ISA are approved automatically for Georgia when they are released by the IAASB. Thus, the ISA does not need to be translated to be legally binding in Georgia. The translation simply follows and the individual auditor has the duty to inform his- or herself of its recent changes.

4. DEVELOPING HUMAN RESOURCES—EDUCATION AND TRAINING

Following the enforcement of the Organic Law on Local Self-government, and the package of laws on local budget and finances, the governance system at the sub-national level has been substantially revised. Even the newly elected local council members and the staff at the municipal administrations still experience problems in adapting to the new realities and making appropriate use of the newly established norms. This situation is further aggravated by the fact that, in terms of audit-services provision, there are no qualified cadres specially trained in local self-government audit and its respective statutory framework. Neither the local providers of trainings in audit or accounting appear active at present in filling this gap.

In a broader context, the audit and accounting profession in Georgia as a whole faces substantial challenges, though they are mainly educational ones. While Georgia has adopted IFRS-based requirements for financial reporting, many members of the profession struggle to understand and implement these requirements. Accountancy and audit education (partially based on the IFRS) is offered at universities, colleges, and business schools in Georgia (both as part of economics or business-administration degrees and as specific accounting degrees), yet the major provider of the proficient accountancy training is the Georgian Federation of Professional Accountants and Auditors.

The federation offers a Georgian-language qualification, based on translations of the United Kingdom's Association of Chartered Certified Accountants (ACCA) 2001 syllabus; however, this qualification can take up to seven years to complete. Students attend evening lectures at the GFPA's Institute for Professional Accountants (IPA) as most are already working full time. The IPA can only accept approximately 150 students

each year, however. Currently, the GFPA has about 450 students in the process of completing the 13 exams of their “ACCA-based Georgian-language qualification,” but none have yet completed all 13 exams.¹⁴

The GFPA also offers support to students through the English-language ACCA, for which students must register individually with the ACCA in Glasgow. This program provides teaching for the first four ACCA papers; though beyond those papers, little or no formal teaching is available in Georgia, and students generally practice self-study. Exams are administered by the British Council office in Tbilisi. Students have to pass the exam and complete three years of relevant training to become ACCA members. It is estimated that up to 20 Georgians have qualified through this route. This route to qualification is considered fair by observers, though unlikely to contribute large numbers to Georgia’s accounting and auditing capacity.

It is also noteworthy that the GFPA offers courses for accountants and auditors to facilitate their continuous professional development. Continuing Professional Development (CPD) is not currently required for auditors or accountants by the Audit Council. However, the pending legislative initiatives (see Section 8) require that an auditor’s qualification is “confirmed by continuous education” (it is also required in EU countries as part of the requirements of auditors in the Eighth Directive).

In addition, the federation offers other accounting courses to non-members, such as a training program for accountants (for beginners) and an IFRS conversion training courses. It offers these across Georgia through its six regional and four district branch offices.

The range of accountancy education and training described above carries the potential to train and develop well-qualified accountants capable of leading the future of Georgian accounting. However, there are substantial capacity constraints, as a very limited number of students can start professional accountancy courses each year, and many drop out due to the costs and the difficulty of the qualification. It has been suggested by many experts that Georgia’s accounting capacity can be more rapidly expanded by addressing the education needs of older members of the profession who are already working as accountants or used to work as accountants.

5. RECENT DEVELOPMENTS, CONTROVERSIES, AND PENDING LEGISLATIVE INITIATIVES

In 2005, the Parliament of Georgia—having the objective to remove the bureaucratic restrictions in Georgia—adopted the Law on Granting the Licenses and Permits. Once put into effect, the law removed the requirement to obtain a license for conducting statutory audits and, thereby, any commercial entity may provide statutory audit services. However, neither the pertinent changes have been introduced to the active Law on

Auditing Activity, nor have the related regulations of the AAC been cancelled, thus far. This, in fact, led to the controversial application of the newly introduced legal norm. Subsequently, at present, the provision of audit services is not regulated in a plain and consistent fashion. The role of the AAC also remains dubious and uncertain with respect to performing its respective functions; now, the Audit Council can neither exercise its licensing functions, nor can it monitor or sanction any misconduct of an auditor, because its only sanction was the revocation of audit licenses.

Many independent experts see this particular novelty (the removing of licensing requirement and its supervision) as a weakness in audit regulation and attest that this practice differs substantially from most other countries, including all EU member states. In those countries, there is a strict regulation of statutory auditors in order to ensure a minimum level of audit quality.

The newly proposed draft Law on Accounting and Audit partially addresses this controversy, as well as suggests a qualitatively different, more consistent, and up-to-date framework for audit and accounting. The initiator of this draft law is the Government of Georgia, namely the Office of the State Minister of Georgia on Coordination of Reforms.

The proposed draft Law on Accounting and Audit re-introduces a registration requirement for auditors and confirms the audit requirement for companies. The draft law requires the auditor to be a “professional accountant,” who must also be a certified member of a professional organization, which in turn is a member of the International Federation of Accountants (IFAC). The law project requires the organization to establish, evaluate, and monitor the quality of audit services provided by auditors. The draft law also defines an accountant as “an adequately qualified person hired by the entity to perform accounting and prepare financial statements.” A “Professional Accountant” is, at the same time, defined in the law as a person “certified as a professional accountant by a professional organization (a member of the IFAC).”

Concurrently, the draft law aims to abolish the Accounting Council and the Audit Commission and delegate their functions to professional organizations, defined in the law as unions of auditors and/or accountants registered under Georgian legislation that are full members of the IFAC. Professional organizations are required to administer the registration of auditors and audit firms. Furthermore, the proposed draft law reintroduces a requirement for professional bodies to monitor the quality of auditors’ service (the outcome of the monitoring by these organizations is not clearly linked though to the possible removal of registration).

It is noteworthy that the given law contains a transitional provision that requires professional organizations registered in Georgia to provide a special accountant qualification program for persons who were previously authorized by the Audit Council. It also requires that an auditor’s qualification is confirmed by their continued education. The requirement for auditors to maintain their technical competence was thus recognized as essential to audit quality.

Finally, one of the major novelties is the two-tiered, financial-reporting structure, proposed in the draft law, with certain defined entities required to apply the International Financial Reporting Standards (IFRS), and all other entities applying simplified financial-reporting requirements. The latter are so-called “temporary accounting standards,” which are issued by the Georgian Federation of Professional Accountants and Auditors (GFPAA). However, there *is no mention in the draft law of which of these standards should be applied* in the course of auditing a local self-government entity. In addition, there is no clear definition of “public-interest entities” (PIEs), as it was suggested by international experts¹⁵ to make sure that the statutory framework is consistent with the requirements across the EC and in other countries.

Importantly, the draft law fully confirms the adoption of International Standards on Auditing (ISAs). It adopts those standards as a whole, not individually, including any updates or new standards, automatically.

6. IDENTIFIED PROBLEMS, PRELIMINARY CONCLUSIONS, AND SUGGESTIONS

Based on the given survey, there is a possibility to outline certain deficiencies of the audit system in Georgia, particularly in regards to the existing shortcomings and inconsistencies in the local self-government audit framework. The following are problems that require foremost consideration:

- The active legislative framework, namely the Law on Auditing Activities and pertinent regulations of the AAC, do not provide for the special licenses and related requirements for auditors of local self-government entities. The new draft Law on Accounting and Audit needs to incorporate respective provisions in a plain fashion.
- The existing legislation, as well as pending legislative initiatives, do not provide for the auditing standards that will be applicable in conducting the auditing of local self-government entities.
- There is a lack of qualified cadres specializing in local self-government audit and its respective statutory framework. Neither the local providers of trainings in audit or accounting appear at present to be filling this gap. The GFPAA and other training providers will need to incorporate a special segment into their training schemes, and, also work closely with Georgian universities to adjust and coordinate their syllabuses. Alternatively, the idea of establishing a special training center for local government (public-administration) employees and civil servants seems to be both timely and apt. This would also help the enhancement of efficiency in the financial/auditory commissions of local councils.

- The scope of the local self-government entity audit in Georgia is more focused on the inspection of financial documents and the checking of the legal compliance with existing norms. There is a lack of performance-audit practice at this stage of the reform that might necessitate further discussion and consideration.
- The rationale of having the legal requirement for invited auditors (by local councils) to submit the audit reports of local self-government unit to the Chamber of Control is somewhat questionable; the GCC conducts the audit over the purposeful and law-compliant use of funds attached to the delegated functions and earmarked transfers, as defined by the respective legislation, and there seems no plainly justified link between these alternative auditory activities. In addition, the active Law on Auditing Activities provides that the auditing activity is carried out independent from the financial control exercised over the economic entities by specially authorized state bodies. Presumably, it would be more consistent if the audit reports and conclusions of an independent (invited) auditor are made for the exclusive use of the local self-government bodies. At least then the law would be clear about the purposes of such mandatory submission and/or in specifying which part of the audit report needs to be submitted to the Chamber of Control.
- The Law on “Granting the Licenses and Permits” removed the requirement to obtain a license to conduct statutory audits. As a result, the provision of audit services is not currently regulated. Following the adoption of this law, neither have the pertinent changes been introduced to the active Law on Auditing Activity, nor have the related regulations of the AAC have been modified. This, in fact, leads to practical irregularities and a controversial application of the newly introduced legal norm. Thus, the role of the Auditing Council remains unclear with respect to performing its respective functions. Not only can the council can not exercise its licensing functions, but it cannot even monitor or sanction any auditor misconduct, because its only sanction power was the revocation of audit licenses.
- Under the current Law on Auditing Activities, the AAC is in charge for the supervision of auditors; however it has barely fulfilled this role, due to inadequate resources and, since June 2005, experienced the formal removal of the licensing requirement for auditors. There is little or no cooperation between the Audit Council and other regulatory institutions. Auditing standards are not currently monitored or enforced by any effective means. This situation requires due consideration and legal delegation of the respective authority to the specially designated organization.
- The auditors’ liability is not fully and adequately regulated. The Law on Auditing Activities requires that the auditor or audit firm cover the damages incurred by the audited entity which were caused by the auditor or audit firm. However, the law could be more specific. In practice, there were examples of attempts to contractually limit auditor liability to the fees received for the statutory audit. It is uncertain

whether such practice would stand a test in a Georgian court, as there have been no legal claims lodged thus far on any dispute between auditor and an audited entity.

- There is no enforceable ethical code of auditors at present. A 1997 decree set out some general ethical requirements for auditors; while later on, the Audit Council made the translated November 2001 version of the IFAC Code of Ethics mandatory for all auditors. However, the Audit Council's *ethics code* has not been updated to reflect the changes made in 2004 and 2005 by the International Ethics Standards Board for Accountants (IESBA) of IFAC, which included enhancements to the section on auditors' independence. More importantly, ethical requirements are not enforceable by the AAC, since formally there are no longer sanctioning possibilities, as noted above.
- Audit firms are required to apply the International Standards of Audit (ISA), though, allegedly, there is currently no quality control or registration of auditors. There might be a need to have the respective legislative norms set the requirement that the professional organization monitor the quality of auditors' compliance with already-enforced international standards. At the same time, the activities of the professional organization in registering auditors could be subject to independent oversight, that might be performed by a non-governmental, non-parliamentary body. The IFAC guidelines should be followed in this respect.

*The proposed draft Law on Accounting and Audit addresses only some of these issues.*¹⁶

APPENDIX

Major Laws and Regulations on Local Self-government and Auditing in Georgia

Law on Auditing Activity (February 1995)

Constitution of Georgia (August 1995)

Law on Chamber of Control (April 1997)

Law on Corruption and Conflict of Interest in Public Service (October 1997)

Law on the Capital of Georgia (February 1998)

Law on Local Duties (May 1998)

Law on the Regulation of Accounting and Reporting (February 1999)

Law on Legal Entity of Public Law (May 1999)

General Administrative Code of Georgia (June 1999)

Law on the Social, Economic, and Cultural Development of Mountain Regions (June 1999)

Resolution of the AAC Collegium on Recognizing/Introducing the International Standards of Audit (September 1999)

Resolution of the AAC Collegium on Approving the Rule on Licensing the Auditing Activity, (November 2002)

Law on the Budgetary System of Georgia (April 2003)

Law on Distribution of Tax, Non-tax, and Capital Revenues among Budgets (December 2004)

Tax Code of Georgia (December 2004)

Organic Law on Local Self-governance (December 2005)

Law on Granting Licenses and Permits (2005)

Law on Local Self-government Unit's Property (March 2005)

Law on Public Procurement (April 2005)

Resolution of the Special Commission on Accounting Standards at the Parliament of Georgia on Introducing the International Standards of Financial Accounting, Bookkeeping, and of their respective interpretations (April 2005)

Presidential Decree No. 687 on Approving the List of Basic (Inalienable) Property Objects to be Transferred to Local Self-government Units (August, 2005)

Law on Local Self-government Unit's Budget (May 2006)

Law on the State Budget (2007)

NOTES

- ¹ The objective of this legislative novelty was to strengthen the capacities of local administrations in carrying out their functions and enable them to provide public services in more efficient manner.
- ² The law was adopted by the Parliament of Georgia on April 15, 1997, with subsequent addenda incorporated.
- ³ The legislation in force also authorizes the MoF as a state-regulating body in the field of accounting and reporting, which is empowered to approve the accounting norms and rules for the legal entities of public law as well as to issue special instructions and execute those into practice. While performing these functions, the ministry is expected to cooperate with the Accounting Standards Commission at the Parliament of Georgia and the independent professional organizations of accountants.
- ⁴ Information about the locally enforced international standards on auditing and accounting is available in later in the report under the subheading on *compliance with international standards*.
- ⁵ The Law on Public Procurement (adopted in April 2005) established a permanent, independent body—(the State Agency on Public Procurement) as a legal entity of public law, which among other functions, carries out the supervision over the legal compliance with the procurement procedures prescribed by the law. It is also in charge of defining the policy on regulating the procurement procedures. The Agency is empowered to request any document or information (including the information of the contract fulfillment) from all purchasing organizations and parties; also, to carry out monitoring during the procurement process in order to ensure the observance of the principles of openness, transparency, fairness, accountability, non-discrimination, effective competition, rational, and free choice.
- ⁶ The law was adopted by the Parliament of Georgia in 1995, and it is still in force despite considerable irregularities observed following the amendments introduced through the framework of the Law on Granting the Licenses and Permits. It is expected that in the near future, the new draft Law on Accounting and Audit will be subject to active deliberations in the Parliament of Georgia. For more detailed comments, refer to the section of this report on *recent developments, controversies, and pending legislative initiatives*.
- ⁷ Currently fulfills the duty of the chair of the Audit Activity Council.
- ⁸ These rules are to be changed due to the new legislative initiatives. For more details please refer to the section of this report on *recent developments, controversies, and pending legislative initiatives*.
- ⁹ For comments on this particular rule (provision), please refer to conclusion of this report.

- ¹⁰ This authority of the AAC is to be eliminated due to new legislative initiatives. For more details please refer to the the section of this report on *recent developments, controversies, and pending legislative initiatives*.
- ¹¹ Report on the Observance of Standards and Codes (ROSC): Accounting and Auditing (January 2007) Working Paper, WB Georgia.
- ¹² The law was passed by the Parliament of Georgia on February 5, 1999 and is in force at present.
- ¹³ For more details please refer to the section of this report on human resources.
- ¹⁴ Report on the Observance of Standards and Codes (ROSC): Accounting and Auditing, Working Paper (2007), WB, Georgia.
- ¹⁵ Report on the Observance of Standards and Codes (ROSC): Accounting and Auditing, January, 2007, Working Paper, WB. Georgia.
- ¹⁶ Still, there is a possibility that the draft law—being actively discussed in the respective Parliamentary Committees—can be adjusted considerably prior to the actual debates at the Parliament’s plenary session.

Survey of Existing Audit Practices in Government in the Republic of Macedonia: Evaluation Study

Elena Atanasova

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FOREWORD

The Local Government and Public Service Reform Initiative (LGI) seeks to improve fiscal transparency and accountability by promoting the good practices of the audit function in local governments. As a first step, LGI is undertaking a survey of existing audit practices across the region. In the Republic of Macedonia, LGI has entrusted this task to the International Institute for Research and Development (IIRD), which conducted the survey on its behalf, highlighting the existing audit practices in the governmental context in the Republic of Macedonia, and pointing out areas of concern, as well as providing policy recommendations for towards a future direction.

The general context is characterized by the decentralization process that took place in the Republic of Macedonia, through the leadership of the Ministry of Finance. With respect to government audit, the key stakeholders are: Ministry of Finance (MoF), the Sector for Public Internal Financial Control (SPIFC), the Central Internal Audit Unit (CIAD), the State Audit Office (SAO), and the Internal Audit Departments (IAD) of the Local Self-government Units (LSGU), in relation to the implementation of the Public Internal Financial Control (PIFC).

The purpose of this audit survey is to report on the system of central and local government audit in Macedonia, to identify needs, and to make recommendations for changes in the legislation and human resources development. This study is intended as a complementary source of information for LGI.

EXECUTIVE SUMMARY

This survey addresses the role of internal and external auditing in the context of government and in terms of legislation and human-resource development in the Republic of Macedonia. It was funded by a grant from the Local Government and the Public Service Reform Initiative of the Open Society Institute–Budapest.

External and internal auditing in the context of the government are of great importance. They serve to ensure that all government activities are carried out in an effective, efficient, lawful, and ethical way, and that stated objectives are met. The government auditors (external and internal) play an important role in Government Financial Management (GFM) by providing objective and thorough assessments as to whether the public resources are used and managed in an effective, efficient, and economical way. Their assessments do not only serve the government officials and the Parliament, but also form the basis for public opinion on the functioning of government structures and the proper management of the public funds. The government audit has several important functions. It acts as an oversight function through which it determines whether the government entities are functioning properly, in accordance with the law and according

to their stated plans. It also provides assurance in that it gives an objective and thorough assessment as to whether public funds are being used and managed appropriately, and whether or not the entities function in an effective, efficient, and economical way. It also provides consultancy, helping the audit subjects achieve their goals and aid in the process of the improvement of the risk management, control, and leadership.

The following questions have formed the content and the structure of this survey: (i) Who are the main stakeholders in terms of government audit and what are their roles? (ii) How far has the legal framework advanced in this area? (iii) What is the scope of the work carried out by the State Audit Office in regards to the financial affairs of local governments, including municipal companies? (iv) What are the reporting lines of state auditors and internal auditors? (v) Is there accessibility and transparency of the audit reports of the internal and the external auditors? (vi) What are the types of audit carried out by the external and the internal auditors? (vii) What are the timelines and regularity of the internal and the external audits? (viii) Who assures auditors' independence and objectivity? (ix) Is there a review of the qualifications required for internal and external auditors? (x) What is the training received by the internal and the external auditors, and does it include training up to date with International Accounting Standards? (xi) What is the function of membership in professional bodies of the internal and the external auditors for the purpose of updating knowledge and sharing experiences? (xii) Is there availability of and accessibility to training institutions for the purpose of continuous improvement of the qualifications of the internal and the external auditors?

The assessments performed throughout the course of this study, the review of the legal framework, and the fieldwork activities demonstrate that significant legislative progress has been achieved in the area of auditing in the government context. However, these changes still need to be fully implemented in practice.

There is a great disparity between the advancements made in the legislative framework and the human-resource development in this area, especially concerning the training for the internal auditors in the local self-government units and the internal auditors in state-owned enterprises.

Our general recommendation is that the future course of direction should be oriented towards the strengthening and the development of the human-resource capacities through the organization of trainings and workshops, as well as fostering further research in this area. This will all aid in the process of giving the true dimensions of a well-functioning system for public internal financial control and accountability, and will stress the importance of audit in government context.

Our second concern is that the government auditor function still remains underperceived, misunderstood by civil society, management, and the public-administration personnel. In order to embrace the internal-audit profession, to demystify its function, and bring it closer to the management, the public-administration personnel, as well as the general public, further research and advocacy is needed in this area. Further efforts

need to be made to promote the function of audit in government context, thereby giving its proper values, which contributes to the smooth functioning of government systems and accountability at all levels..

Models to achieve this can vary, from organizing trainings and workshops for internal auditors and executives, to publishing reader-friendly guides on audit in government context in the Republic of Macedonia. Future research in this area is needed and strongly desired.

Specific recommendations are included in the closing part of this study.

LIST OF ABBREVIATIONS

CHU	Central Harmonization Unit
CIAD	Central Internal Audit Department
EAR	European Agency for Reconstruction
EC	European Commission
EU	European Union
EOSAI	European Organization of Supreme Audit Institutions
FMC	Financial Management and Control
GFM	Government Financial Management
ICA	Institute for Certified Auditors
IIRD	International Institute for Research and Development
IA	Internal Audit
IAD	Internal Audit Department
IC	Internal Control
IFAC	International Federation of Accountants
IIA	Institute of Internal Auditors
INTOSAI	International Organization of State Audit Institutions
LGI	Local Government and Public Service Reform Initiative
LSA	Law on State Audit
LSGU	Local Self-government Units
NCA	Netherlands Court of Audit
MoF	Ministry of Finance
PIFC	Public Internal Financial Control
SAO	State Audit Office
SPIFC	Sector for Public Internal Financial Control
WGEU	Working Group on Environmental Auditing

1. COUNTRY CONTEXT

As of December 17, 2005, the Republic of Macedonia became a candidate country for European Union (EU) accession. One of the biggest priorities for Macedonia is the improvement of efficiency and transparency within the public sector. Within the enlargement framework, the EU has established a number of principles that relate to sound financial management of public resources, regardless of whether these resources are national or a result of international financing. Sound public internal financial control finds its place and importance in the requirements of the *acquis communautaire* for the Republic of Macedonia. The country has committed itself to the reform of the accounting and auditing system by harmonizing the national legislation with the legislation of the EU. These reforms can be achieved not only by changes in the legislation but, more importantly, through the adequate training and development of the human-resource capacities in this area.

1.1 Internal Audit in Governmental Context

The concept of internal audit is relatively new to government institutions in the Republic of Macedonia. The activities for development of the system of internal audit in the public sector in Macedonia were initiated in 2000, through the changes that were made in the Law on Budgets, which contained a subsection on internal audit. At a later stage, within the Ministry of Finance (MoF), the Central Internal Audit Unit (CIAD) was established. Its role was to regulate, develop, and harmonize the system of internal audit in the public sector in Macedonia. In 2004, within the framework of a World Bank project named “Development Politics of the Republic of Macedonia in the Area of Internal Audit and Training,” the Dutch Trust Twinning Project, financed by the Netherlands, held trainings on internal audit and published a manual on internal audit. Training was organized for future internal auditors by Dutch experts, involving participants from 13 central-level institutions. This was followed up by the adaptation of the first Law on Internal Audit in the Public Sector in the Republic of Macedonia, in October 2004. According to this law, the internal audit units were to be established within the budget users, and were obliged to follow the specifications of this law. A paper for the development of internal audit and strengthening of the control in the budget users and the funds was adopted by the government, which stated that internal audit units were to be established in the 42 municipalities (out of a total of 85 municipalities in the country) with populations above 15,000 inhabitants, as well as in an additional 15 institutions on the central level (Appendix 1).

In the years 2005–2006, the European Agency for Reconstruction funded a project called “Technical Assistance to the Ministry of Finance for Development of Internal Audit.” Through the framework of this project, the auditors of the CIAD, the first- and second-line budget users, as well as the municipalities, were trained in compliance

audit. At a later date, the paper on Public Internal Financial Control (PIFC) was drafted and adopted by the Macedonian Parliament. Thus far, 48 internal auditors have been appointed to the central level in the total of 28 Internal Audit Units established (Appendix 2). In the local self-government units, a total of 20 Internal Audit Departments were established, and 21 internal auditors have been appointed (Appendix 3). The European Agency for Reconstruction also funded a project named “Technical Assistance to the Ministry of Finance for Fiscal Decentralization,” whose objective was to enhance and harmonize the fiscal infrastructure for decentralization, and included a component on the application of international accounting standards.

In February 2007, the Law on Public Internal Financial Control was adopted by the Parliament. According to this law, the CIAD was renamed to the Sector for Public Internal Financial Control (SPIFC). The role of the SPIFC was extended to include the management and oversight function over the harmonization of financial management and control, as well as to regulate, develop, and reconcile the system of internal audit in the public sector. The Law on Internal Audit in the Public Sector was amended in February 2007, to include several new provisions, such as Article 17, which specifies that in the local self-government units, the internal auditors will no longer be appointed by the Municipality Councils on the basis of a four-year mandate, but will be employed as full-time employees, on the basis of a contract of unlimited duration. This law clearly defines and assigns the advisory and guidance role of the internal audit units within the budget users and the local self-government units to the Ministry of Finance, to the Sector for Public Internal Financial Control.

With a view to strengthening the PIFC, in April 2007, a twinning project was launched between the MoF and the Netherlands (the National Academy for Finance and Economics). The project will aid in the development of the PIFC and will aid in the strengthening of the administrative capacity for financial management control and internal audit. Within its framework, however, the project does not encompass a component on providing training for the internal auditors in the local self-government units and the internal auditors in state-owned enterprises.

1.2 External Audit in Government Context

Within the government of the Republic of Macedonia, the external-audit function is allocated to the State Audit Office (SAO). The SAO was established on the basis of an act adopted by the Parliament and as per the Law on State Audit (adopted in 1997), as well as the amendments to this law in 2003 and 2004. Currently, in terms of the development of the legal framework, the State Audit Office is in the process of preparing a new law proposal that would further aid in the process of the SAO’s development, and in bringing the State Audit Law closer to European law.

According to the Law on State Audit, the SAO acts as an audit institution. The SAO is managed by the Chief State Auditor, who is elected by the Parliament of the Republic of Macedonia. This person is appointed with a mandate of ten years, and has a deputy who is also elected by the Parliament with a mandate of 10 years. Through its mandate, the State Audit Office acts as an external auditor that is responsible for carrying out audits on the Budget of the Republic of Macedonia, the budgets of the local self-government units, the budget of the funds, the budget funds' users and their spending units, the state-owned enterprises, the National Bank of the Republic of Macedonia, the political parties funded by the Budget of the Republic of Macedonia, the agencies and other institutions established by law, the legal entities in which the state is a major stakeholder, and other institutions financed from public funds and beneficiaries of EU funds and other international institutions. The SAO reports to the Parliament and submits an Annual Report on all its activities for the preceding year.

The SAO is mandated to carry out financial and performance audit. In carrying out these audits, the SAO is working in accordance with the Law on State Audit (LSA) of the Republic of Macedonia, INTOSAI and IFAC Auditing Standards, the INTOSAI Code of Ethics, and the LSA provisions. In the course of its work, the State Audit Office has developed a Performance Audit Manual as well as a Financial Audit Manual, both of which are subject to constant update and improvement.

The State Audit Office has been a member of INTOSAI (the International Organization of Supreme Audit Institutions) since March 29, 2001; EUROSAI (the European Organization of Supreme Audit Institutions), since May 31, 2002; as well as the Working Group on Environmental Auditing (WGEA), since October 2002, and the IT Working Group, since December 2005.

In Macedonia, a few projects have been funded and implemented in regards to the State Audit Office, including: a project for support to the State Audit Office, administered by the World Bank and financed by the Dutch Government in the years of 2003–2005; also the SAO has established bilateral cooperation with the Netherlands Court of Audit on the basis of a twinning project that will last until the year of 2008. This project is financed by the Dutch Government. The EAR-funded project entitled Technical Assistance to the Ministry of Finance for Development of Internal Audit, also included participants from the State Audit Office within its training module.

1.3 Cooperation between the Ministry of Finance and the State Audit Office

The Ministry of Finance and the State Audit Office have been cooperating in the fields of training and strengthening the management and control system for public funds. In October 2006, a formal protocol was signed by the Ministry of Finance and the State Audit Office, laying down the areas of cooperation among the two institutions (Appendix 5).

2. OBJECTIVES, APPROACH, AND METHODOLOGY

2.1 Objectives

The purpose of this audit survey is to report the system of government audit on central and local level in Macedonia, to identify the needs, concerns, as well as good practices, and to make recommendations for changes in legislation and human resources development.

2.2 Approach and Methodology

The methodology included the collection and review of relevant documents, including the review of the legal framework, on-site fieldwork and observation, personal interviews, completed questionnaires, review and analysis of documentation provided by the interviewees, and review of reports and general background information from a variety of sources. Detailed interview notes and summaries were completed for each interview and all relevant documents were summarized, implemented in the body of this survey, and carefully archived.

2.3 Limitations of the Evaluation Methodology

The internal-audit profession in the government context is still evolving in response to new projects, laws, and programs enacted.

The State Audit Office is still evolving in response to the new projects, laws, and programs enacted.

3. LEGISLATION

3.1 The Scope of Duties and Responsibilities of the State Audit Office

The scope of the State Audit Office (SAO) authorities and responsibilities, as stipulated in the Law on State Audit, is to perform audits of the Budget of the Republic of Macedonia (the State Budget); the budgets of the local government units; the budgets of funds; the budget-funds' users and their spending units; the state-owned enterprises founded by

the Republic of Macedonia; the National Bank of the Republic of Macedonia; the legal entities in which the state is a major shareholder; the political parties funded by the Budget of the Republic of Macedonia; the agencies and other institutions established by law; the other institutions financed from public funds; and beneficiaries of EU funds and other international institutions. The audits are carried out in accordance with the SAO Annual Program, and the subjects are selected on the basis of certain criteria, such as size, risk assessment, amount of public funds allocated, on the basis of requests from the Parliament or on the basis of the recommendations issued in previous years.

Table 1.
Analysis of Total SAO Coverage of the State Funds for 2005
(In MKD Thousands)

Subjects	Executed budget for 2005	Extent of audit	Percent of extent/total budget	Percent of extent according to type of subject
1	2	3	4 = 3/2	5 = 3/2
Budget of the Republic Macedonia	74,598,389	37,331,591	25.53%	50.04%
Budget of LSGU	5,003,941	1,945,064	1.33%	38.87%
Budgets of funds and health institutions	66,615,565	56,030,263	38.32%	84.11%
Total	146,217,895	95,306,918	65.18%	

3.2 What Are the Reporting Lines of the State Audit Office?

The SAO reports to the Parliament and submits an annual report on the conducted audits and operations that it has carried out in the preceding year. These reports are submitted to the Parliament on an annual basis, no later than September 30 of the following fiscal year. The report contains information not only on the conducted audits, but also information on the implementation of the recommendations stipulated in the audit reports. Additionally, it describes the system's weaknesses as identified in the internal controls and internal audit documents. It also contains information on all material cases of corruption that were reported to the State Anti-corruption Commission or other competent authorities.

The individual reports concerning conducted audits in the LSGU, Public Enterprises, and other government institutions are submitted to the executive managers of the budget entity; and in the case of the LSGU, to the councils as well. When financial matters are in question, these individual reports are also submitted to the Ministry of Finance.

3.3 Accessibility and Transparency of the Audit Reports of the State Audit Office

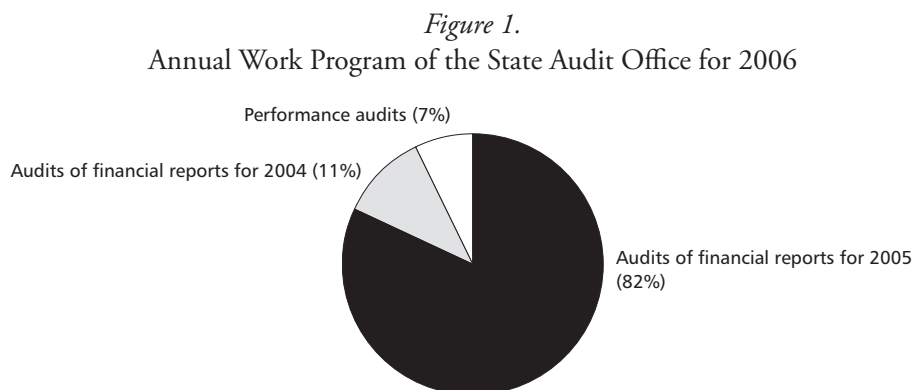
The State Audit Office publishes an Annual Report that is submitted to the Parliament, and all its final reports are accessible on its web-site. As of December 2005, the SAO has begun publishing a monthly bulletin that contains information on recent developments in the area of audit in Macedonia. The General State Auditor informs the public on relevant audit results accordingly. Through these means, the reports are transparent, readily identifiable, and accessible to the general public and all interested parties.

3.4 What Types of Audits Are Carried out by the State Audit Office?

In the scope of its mandate, the SAO carries out Financial Audit and Performance Audit.

The government auditing is carried out in compliance with the LSA provisions, the INTOSAI and the IFAC Auditing Standards, the INTOSAI Code of Ethics, and other relevant legislation in the Republic of Macedonia. State audit, in terms of the law, means: examination of documents, papers and reports on performed internal controls and internal audits, examination of accounting and financial procedures, electronic data and information systems, and other records, to assess whether the financial statements truthfully and fairly present their financial position, and to examine whether their financial activities are in accordance with the adopted accounting policies and accounting standards. They also examine financial transactions defined as 'government expenditures' with respect to their legal and authorized spending; as well as an assessment as to whether or not the funds are spent economically, efficiently, and effectively (a performance audit).

In Figure 1, reference is made to the structure of all the types of audits carried out by the SAO, according to their annual program for 2006.



3.4 Are Local Governments Required to Appoint External Auditors to Cover Financial Affairs Not Scrutinized by the State Audit?

According to the Law on State Audit, the State Audit Office performs regular annual audits of the financial reports of the LSGUs. The law does not limit the choice of commercial auditors, therefore, at their own initiative, and in accordance with their own needs, the LSGUs can engage, in addition to the regular audits performed by SAO, commercial auditors. According to our research and interviews conducted, no such practice has been implemented as yet.

3.5 To What Extent Are Qualified Auditors Affordable, Particularly by Small Local Governments?

The audits carried out by the SAO are mandatory under current law. These audits are partially covered through funds from the State Budget, and the rest is to be paid by the audited LSGU, according to the tariffs of the SAO audits approved by the Parliament. The statistics have shown that the SAO has difficulties in obtaining the funds from the LSGUs and the other government institutions owed for the audit services performed, presumably because when planning the budgets, the cost of the state audit is not included in the budget proposals for the following fiscal year.

Regarding internal auditors: according to the strategic plan of the MoF, it was planned for internal-audit departments to be established within each municipality with a population of over 15,000 inhabitants. According to the Law on Internal Audit in the Public Sector, and according to the Law on Financial of the LSGU, the municipalities can share administrative resources. Therefore, an internal auditor can be shared by a few smaller municipalities in close geographical proximity, thus sharing the cost.

3.6 Do External Auditors Cover Local Budget Institutions?

In accordance with the law, the State Audit Office covers the local self-government units and public enterprises as external auditor.

3.7 Who Has Access to the Reports of the Internal and the External Auditors?

- **State Audit Office**

The State Audit Office publishes all of its reports on its website, thereby assuring access to them to the general public. The State Audit Office submits the Annual Report to the Parliament. Upon completion of each individual audit, the reports are submitted to the executives of the audited entities. When financial matters are in question, they are submitted to the Ministry of Finance; and when cases of fraud are detected, to the State Commission Against Corruption, the Ministry of Internal Affairs, and the Public Prosecutor's Office.

- **Internal Auditors**

The Ministry of Finance, the State Audit Office, as well as the Management (mayors and councils) of the budget entity have access to the reports of the internal auditors. These reports are not published, nor are they made available to the general public.

3.8 Are Local Governments Required to Employ Internal Auditors?

The local self-government units with populations of above 15,000 are required to employ internal auditors (this comprises a total of 42 LSGUs). In the case of smaller municipalities, the law has a provision stating that the internal auditor can be shared by several smaller municipalities in close geographical proximity, thus, the cost of having an internal auditor is being divided among the municipalities.

3.9 Reporting Lines of Internal Auditors?

Within the local self-government units, as per the Changes on the Law on Internal Audit, according to Article 7 of *Official Gazette No. 22* from February 23, 2007, the internal auditors are responsible to, report directly to the executives, i.e., the local mayors (Appendix 6).

3.10 Do Internal Auditors Inspect Budget Institutions (LSGUs and Municipal Companies)?

As required in the Law on Internal Audit, the Internal Audit Units have been established in most institutions at the central level, first line, and at the level of second line of budget users (Appendix 2), and in some of the local self-government units (Appendix 3), as well as in some municipal companies (Appendix 4). Within each organizational entity, internal auditors inspect these budget institutions and have access to all documents that are needed for the successful implementation of the audit.

3.11 Do Internal Auditors Cover Issues of Efficiency as well as Legality?

The internal auditors perform *compliance audits*, on the basis of the *system-base* approach on the evaluation of the internal controls. The internal auditors are not yet trained in performing a *financial audit* or *performance audit*. Currently, these types of audits are carried out by the State Audit Office.

3.12 Who Audits Municipal Companies?

Municipal companies are audited by the State Audit Office, as prescribed by their mandate in the Law on State Audit. According to the Law on Internal Audit in the Public Sector, municipal companies are required to appoint internal auditors. Thus far, only two municipal companies have established internal audit units. (Appendix 4).

3.13 To Whom Do the Internal and the External Auditors Report and on What?

The State Audit Office prepares a report that is submitted to the legal representative of the organization, i.e., the executive manager. These reports are also submitted to the Ministry of Finance and as a part of the Annual Report submitted to the Parliament. The SAO prepares an annual audit report of the financial statements and the performance audit. The internal auditors carry out audits in accordance with their annual plan, though they also carry out a compliance audit. They report directly to the executive management of the organization. (Appendix 6.)

3.14 How Regular and Timely Are External and Internal Audit?

The Internal and External Audits are carried out in accordance with the developed and approved Annual Audit Programs. The SAO usually performs audits once a year, in accordance with its annual plan of activities, or on the basis of a request. The internal audits are carried out in accordance with the approved plan of activities of the Internal Audit Departments. The scope and number of audits carried out during the year depends largely on the size, complexity, and the financial resources of the designated budget entity.

4. HUMAN RESOURCE DEVELOPMENT

4.1 What Qualifications Do Internal and External Auditors Possess?

- **Internal Auditors**

Government internal auditors must possess the following qualifications and fulfill the following prerequisites:

- Completion of university education: a Bachelor's Degree in Economics or a Bachelor's Degree in Law, or other related areas, in accordance with the systematization act of the organization;
- At least two years' working experience in internal audit, external audit, or finance.

Currently, there is no formal certification for internal auditors in the public sector.

- **State Auditors**

Certified state auditors must possess the following qualifications and fulfill the following prerequisites:

- Citizenship of Republic of Macedonia;
- Completion of a university education: Bachelor's Degree in Economics or a Bachelor's Degree in Law;
- At least five years' working experience in accounting or finance, or three years of audit experience or control;
- Certified State Auditor certificate, obtained through examination, organized by the chief auditor and an independent examining commission.

4.2 How Are Their Independence and Objectivity Assured?

The internal and external auditors do not have any management capacity or control in the organization. They are not responsible for the establishment and development of the internal control system, nor are they involved in any financial matters. The Internal Audit Department is functionally independent of all other entities in the organization and the reporting structure is that of the internal auditor by way of the mayor or management executive (Appendix 6). The Law on Internal Audit guarantees the independence and objectivity of the auditors. However, the frequent changes in the management structure, combined with a lack of understanding regarding the internal audit function's place in the organizational hierarchy, may pose an obstacle to fully achieving independence and objectivity.

4.3 Is Their Training Adequate to Apply European Accounting Standards as well as the Modern Concepts of Value for Money?

The International Accounting Standards and the International Audit Standards have been translated into the Macedonian language. Some trainings have been provided through various cooperation programs. However, the internal auditors in the public sector still lack adequate training and experience in order to apply the modern concepts of *value for money*, and still require further training in European accounting standards. The lack of technical skills, such as computer and English-language knowledge, are impediments to these persons who would follow the major developments in the area of audit. The internal auditors have not yet received training in performing *financial audit*, and therefore clearly need further advancement and development in this area, especially the internal auditors of the LSGUs and the internal auditors of state-owned enterprises.

4.4 Do the Government Auditors Belong to Professional Associations Capable of Updating Knowledge and Standards?

The State Audit Office has been a member of: INTOSAI (the International Organization of Supreme Audit Institutions) since March 29, 2001; EUROSAI (the European Organization of Supreme Audit Institutions), since May 31, 2002; also its Working Group on Environmental Auditing (WGEA), since October 2002, and the IT Working Group, since December 2005.

The MoF and the internal audit units within the budget institutions, including the internal audit units in the LSGUs, are not members of professional audit bodies.

4.5 Are there Training Institutions Which are Able to Update and Upgrade Professional Standards?

Some locally established consulting companies occasionally provide trainings on audit, which include a review of specific standards, or training regarding changes and additions to the state audit law. A professional chapter of internal auditors has yet to be established, and Macedonia as a country, is not yet a member of the International Institute for Internal Auditors. Thus far, the internal auditors' advancements depend on the trainings included in various joint programs with the EU.

5. CONCLUSIONS AND RECOMMENDATIONS

Significant legislative progress has been made in the area of auditing in the government context. The basic principles and the basic institutions are in place and are functioning. The Law on Internal Audit in the Public Sector, and the Law on State Audit, have been amended. Further legislative changes are expected in terms of the Law on State Audit for the purpose of bringing closer the legislation to EU and European standards. In February of this year (2008), the Law on Public Internal Financial Control was adopted by the Parliament, and the Strategy Paper on Development of Public Internal Financial Control (PIFC), was drafted in accordance with the time framework set for the development of a system of public internal financial control, and the further development of the internal audit function. The standards for auditing and accounting have been amended and have been translated into the national language of Macedonia.

- 1) Even though significant progress has been achieved in the legislative framework, these changes need to be fully implemented in practice. There is a great disparity between the advancements made in the legislative framework and the human-resource development in this area, especially concerning the lack of training and practical experience of the internal auditors at central and local levels, including the internal auditors appointed in the state-owned enterprises.

Clearly, the future course of direction should be oriented towards the strengthening and the development of the human-resource capacities in this area, through the organization of trainings, workshops, on-the-job-trainings, and the encouragement of further research. This will all aid in the process of bringing the internal auditor closer to international audit standards and a more professional conduct of work.

- 2) This study revealed that the internal auditors in the government institutions have not received training in conducting financial audit and performance audit, both of

which are crucial in the smooth functioning of all entities. Ultimately, government auditing strengthens public governance, by providing accountability and protecting the core values of government, ensuring managers and officials' conduct, and the public's business transparently, fairly, and honestly.

Regarding this area, we strongly recommend that the future course of action be oriented towards the organization of trainings on performing *financial audit* and *performance audit* for internal auditors. Proficiency in these types of audits is crucial, especially for large-budget entities such as the health fund, which, for years now, has been in need of a good performance audit, in order to reveal all its weaknesses in its internal controls and improve its functioning.

- 3) In the current state of affairs in Macedonia, it is crucial for both the internal and external auditors to have excellent knowledge of international accounting standards, in order to fairly and truly apply the concept of *value for money*. Clearly, this is essential for receipt of the precession of the IPA structural funds within the country, and its successful audit.

Our course of study revealed that the government auditors lack training in International Accounting Standards. We strongly recommend future trainings be organized, and oriented towards this area, in order to strengthen the human-resource capacities. The improved competences of the individual auditors will prove to be of great importance to the entire entity. To this end, we would strongly suggest the involvement of local trainers, who would later pass on their experience to their peers.

- 4) Our research revealed that the internal auditors in the local self-government units and the internal auditors of the public-owned enterprises still lack basic training in internal audit. Even though strengthening of the human resource capacities in this area is strongly needed and desired, thus far, only very a few trainings have been organized for this group.

The future direction should be oriented towards providing both theoretical and practical trainings to the internal auditors in the LSGU, and the public-owned enterprises, including trainings in the International Accounting Standards, and familiarization with the relevant legislative framework.

- 5) Over the course of our study, we concluded that the internal auditors still lack training in the areas of time-management, teamwork, and resource sharing, etc. Though not essential, these areas, or, so-called *soft skills*, need to be developed and further strengthened for each individual auditor.

Developing programs and training modules for strengthening these *soft skills* for each individual auditor would result in greater effectiveness, efficiency, and cooperation over the course of their work.

- 6) Even though the number of employees of the SAO and the appointment of internal auditors at central and local levels has been gradually increased in the past few years, the current understaffing, supplemented with the lack of training, still present a challenge and represent area that requires improvement.

Efforts towards recruiting and hiring competent personnel to carry out the audit functions should be made in regards to the staffing the IAU, at central and local level.

- 7) There is no formal certification for government internal auditors.

It is, therefore, strongly advisable for certification procedures for the internal auditors to be initiated and introduced, thus ensuring that candidates with the right skills and capacity are appointed for the function of government internal auditor.

- 8) There is neither a professional training institution nor an institute for internal auditors currently established that would serve in the continuous education of audit personnel.

Efforts should be made to establish both a training institution for internal auditors and a Macedonian chapter of the Institute of Internal Auditors.

- 9) The government-audit function still remains misunderstood by civil society, management, and public-administration personnel.

In order to assimilate the internal audit profession, demystify its function, bring it closer to the management and personnel, as well as the general public, further research and advocacy is strongly needed. Further efforts need to be made to promote the function of audit in the government context, establishing its proper value, raising the issues of its importance to the well functioning of systems, and accountability on all levels of the government. Models to achieve this can vary, ranging from organizing trainings and workshops for internal auditors and executives, to publishing reader-friendly guides on audit in government context in the Republic of Macedonia.

Table A1.
List of Self-government Units in Macedonia

Skopje			
Aerodrom	Aracinovo	Berovo	Bitola
Bogdanci	Bogovinje	Bosilevo	Brvenica
Butel	Valandovo	Vasilevo	Vevcani
Veles	Vinica	Vranesnica	Vrapciste
Gazi Baba	Gevgelija	Gostivar	Gradsko
Debar	Debarca	Delcevo	Demir Kapija
Demir Hisar	Dojran	Dolneni	Drugovo
Gjorce Petrov	Zelino	Zajas	Zelenikovo
Zrnovci	Ilinden	Jegunovce	Kavadarci
Karabinci	Karpos	Kisela Voda	Kicevo
Konce	Kocani	Kratovo	Kriva Palanka
Krivogastani	Krusevo	Kumanovo	Lipkovo
Lozovo	Mavrovo i Rostusa	Makedonska Kamenica	Makedonski Brod
Mogila	Negotino	Novaci	Novo Selo
Oslomej	Ohrid	Petrovec	Pehcevo
Plasnica	Prilep	Probistip	Radovis
Rankovce	Resen	Rosoman	Saraj
Sveti Nikole	Sopiste	Staro Nagoricane	Struga
Strumica	Studenicani	Tearce	Tetovo
Centar	Centar Zupa	Cair	Caska
Cesinovo-Oblesevo	Cucer Sandevo	Stip	Suto Orizari

APPENDIX 2

Plan for Staffing the Internal Audit Units for the Institutions
at the Central Level for 2007

Table A2.
Plan for Staffing the Internal Audit Units for the Institutions
at the Central Level for 2007

No.	Public-sector subjects at central level	Planned minimal number of internal auditors by the end of 2007	Number of internal auditors as of December 31, 2006	Planned employments/transfers for internal auditors in 2007
1.	Customs Administration	3	1	2
2.	Ministry of Foreign Affairs	3	1	2
3.	Ministry of Internal Affairs	3	2	1
4.	Ministry of Labor and Social Policy	4	3	1
5.	Ministry of Agriculture	4	2	2
6.	Health Insurance Fund	7	6	1
7.	Service for General and Common Affairs	2	1	1
8.	Public Revenue Office	5	4	1
9.	Supreme Court	3	1	2
10.	Ministry of Culture	3	3	0
11.	Pension Fund	3	3	0
12.	Ministry of Education and Science	4	2	2
13.	Ministry of Finance	3	1	2
14.	Employment Agency	2	2	0
15.	Ministry of Defense	3	1	2
16.	Government of Macedonia	2	1	1
17.	Ministry of Local Self-government	1	0	1
18.	Ministry of Environment and Spatial Planning	2	1	1
19.	Central Registry	2	2	0
20.	Ministry of Health	2	0	2

No.	Public-sector subjects at central level	Planned minimal number of internal auditors by the end of 2007	Number of internal auditors as of December 31, 2006	Planned employments/transfers for internal auditors in 2007
21.	State Geodetics Office	3	1	2
22.	Road Fund	2	1	1
23.	Public Prosecutor's Office	2	1	1
24.	Ombudsman's Office	1	0	1
25.	Statistics Bureau	3	1	2
26.	State Archives	2	1	1
27.	Ministry of Justice	3	1	2
28.	Intelligence Agency	1	1	0
29.	Ministry of Economy	3	1	2
30.	Civil Servants Agency	1	0	1
31.	Parliament of Macedonia	2	1	1
32.	Ministry of Transport	3	2	1
33.	State Audit Office	1	0	1

APPENDIX 3

Appointed Internal Auditors in the Local Self-government Units
as of June 15, 2007*Table A3.*Appointed Internal Auditors in the Local Self-government Units
as of June 15, 2007

No.	Name of the Local Self-government Unit
1.	Local Self-government Unit, Kumanovo
2.	Local Self-government Unit, Strumica
3.	Local Self-government Unit, Delcevo
4.	Local Self-government Unit, Radovis
5.	Local Self-government Unit, Gostivar
6.	Local Self-government Unit, Bogovinje
7.	Local Self-government Unit, Tetovo
8.	Local Self-government Unit, Lipkovo
9.	Local Self-government Unit, Cair
10.	Local Self-government Unit, Bitola
11.	Local Self-government Unit, Prilep
12.	Local Self-government Unit, Sveti Nikole
13.	City of Skopje
14.	Local Self-government Unit, Struga
15.	Local Self-government Unit, Gevgelija
16.	Local Self-government Unit, Kriva Palanka
17.	Local Self-government Unit, Kicevo
18.	Local Self-government Unit, Veles
19.	Local Self-government Unit, Karpos
20.	Local Self-government Unit, Kisela Voda

APPENDIX 4

Appointed Internal Auditors in the Local State-owned Enterprises as of June 2007

Table A4.

Appointed Internal Auditors in the Local State-owned Enterprises as of June 2007

No.	Name of the State-owned Enterprise
1.	Public Enterprise <i>Makedonski Sumi</i>
2.	Public Enterprise <i>Pretprijatie za stopanisuvanje so stanben i deloven prostor</i>

APPENDIX 5

Protocol For Cooperation

Protocol
for
Cooperation

Signed October 20, 2006

Between

Ministry of Finance, Represented by Trajko Slaveski, Minister

and

State Audit Office, represented by Dragolljub Arsovski, Chief State Auditor

Article 1

The Ministry of Finance and State Audit Office (in following text: both parties) signing this Protocol are expressing their will for mutual cooperation regarding the exchange of information in the areas of financial management and control, internal audit in the public sector, and state audit.

The purpose of the cooperation is to enable the successful execution of the stated functions in order to strengthen the management and control system for public funds, and providing high-level competency for both institutions in the carrying out of the audits.

Article 2

Both sides will cooperate according to the Law on Internal Audit in the Public Sector, the Law on State Audit and its bylaws, which regulate this area without any violation of the provisions of these laws, and the Lima Declaration for addressing the guidelines of audit principles which relate to the Supreme Audit Institutions and concern their independency.

Article 3

Both sides will exchange information about: adopted audit standards; methodological guidelines and manuals for internal and state audit; annual programs for audit activities, risk areas during the planning of the audits; programs for the education of staff, and others information of common interest.

Article 4

Representatives of both sides will convene once every six months to exchange information on the progression of the provisions of this protocol.

Article 5

Towards accomplishing the goals of this protocol, both sides will work professionally but data and information will be used only for internal needs and according to existing laws.

Any kind of publishing of information in a public forum from either party will be considered a violation of the professional and ethical norms, and will be considered a violation of purpose of this protocol.

Article 6

Both sides can suggest amendments to this protocol on paper.

Article 7

These protocols will enter into force as of the day of signing.

Article 8

This protocol consists of four samples, two from each side.

For the Ministry of Finance of the RM

For the State Audit Office

**Trajko Slavevski, Ph.D.
Minister**

**Dragoljub Arsovski, Ph.D.
Chief State Auditor**

APPENDIX 6

Reporting Lines of Internal Auditors

Figure A6.1
Organizational Structure of the Municipality of Veles

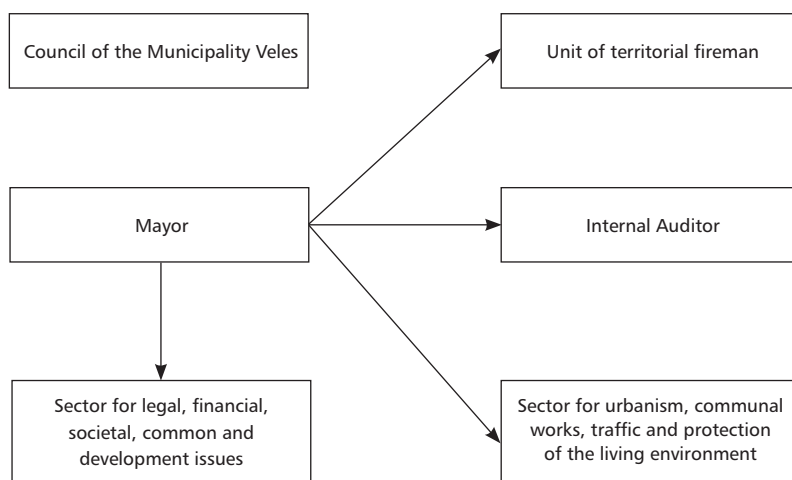
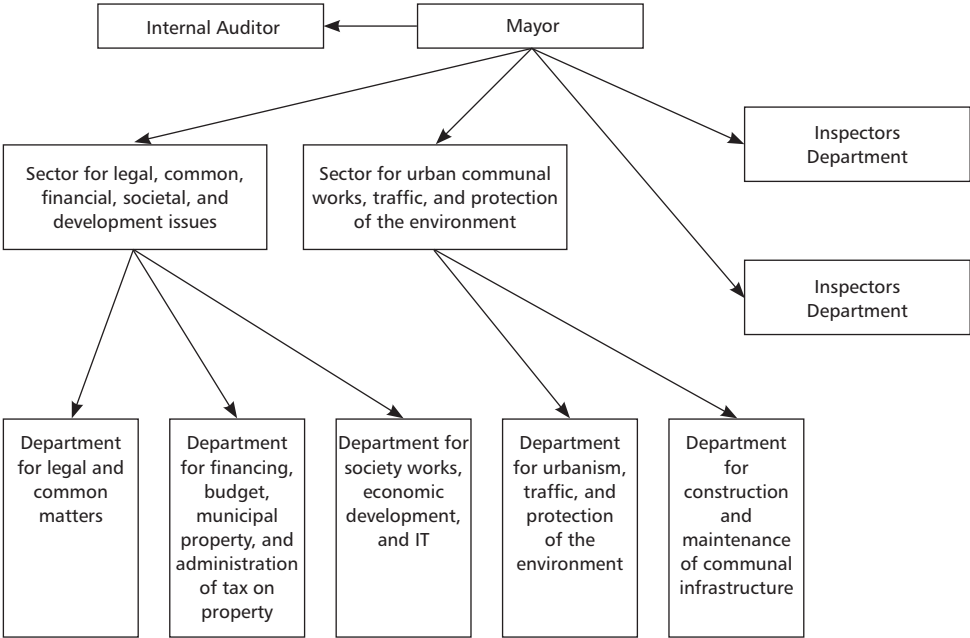


Figure A6.2
Municipality of Kriva Palanka



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Audit Function Survey Moldova

Gabriela Calusero

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1. INTRODUCTION

General Overview. Macroeconomic Considerations. Moldova's Efforts for EU Integration and Legislation Harmonization

Moldova is one of the poorest countries in Europe with an USD 460 GDP per capita. It has a population of 4.3 million citizens. An impressive number of citizens live abroad and their remittances represent an important revenue source for Moldova's economy.¹ Inflation decreased over the period 1999–2002 (from 39 percent to 4.4 percent) followed by a jump in 2003 to a level of 15.7 percent and eight percent in 2004; over the period 2006–2007, inflation stabilized at about 11 percent. The economy is still dominated by state-owned enterprises, including agriculture (wine and tobacco industries), national and local utilities, infrastructure, and other public services. The largest three enterprises are state owned (or the state holds the majority of shares).

Over the past years, Moldova has made progress towards integration with Western and Central European countries, particularly with Romania. This makes European Union economic and legal models more and more applicable in Moldova.

Since 1992, Moldova has developed economic and political relations with its western neighbors, maintaining, at the same time, tense relations with some countries from the CIS (Commonwealth of Independent States).

While there is no firm commitment for European integration, Moldova's leaders are aware of the economic benefits resulting from adjusting their national standards and regulations to fit with the European Union.

2. LEGAL AND INSTITUTIONAL FRAMEWORK

Moldova is a two-tier government, comprising a central government and subnational governments. The subnational governments include 38 *raions* and local governments (municipalities, towns, communes, and villages). Each local government has its own budget, which is also part of the consolidated national budget.

The legal framework for public accounting, financial reporting, and audit is currently undergoing reform. There are several important laws under discussion, or about to be promulgated by the president, as the laws currently applicable are rather old and obsolete.

The most important laws dealing with accounting, reporting, and audit are:

- a) the Law on Accounting;
- b) the Law on Public Finances;
- c) the Law on Audit.

The Law on Public Administration also deals with reporting, internal control, and internal audit issues. For local utilities, the Law on Stock Companies also includes relevant provisions.

The Law on Stock Companies, issued in 1996,² provides the requirements for the annual financial statements of stock companies. The financial statements need to be reviewed and approved by the Censors' Commission. Thereafter, the financial statements are subject to shareholders' approval (along with the Censors' Commission report). The financial statements have to be submitted for the shareholders review 10 days before the general assembly meeting. There is no provision imposing audit; however, shareholders having at least 10 percent of the shares may request an independent audit (and they also have to pay for the required audit).

The Censors Commission review cannot stand as a substitute for an independent audit. Article 71 of the above-mentioned law stipulates that "the Commission has to exercise a form of control over the financial and economic activities of the company."

Appointing the censors, and the operations undertaken by the censors, is subject to the internal regulations of the respective company. The censors may be the company's employees, but they cannot have executive functions and cannot be part of the accounting department. The censors must be qualified in accounting, finance, or economics.

Article 72 provides details of the censors' role and responsibilities. However, their role is less restrictively defined than the role of an auditor. As operating rules are to be established by the company, the control mechanism is missing and no connection is made to audit standards, thus the accuracy and credibility of the censors' report cannot be as great as that of an independent audit report.

The Accounting Law, issued in 1995,³ provides detailed instructions on the accounting registries to be held by local governments and enterprises, but fails to be as descriptive on the financial reports' content. The law includes provisions dealing with the accounting process (organization, documentation) and the forms of reporting. The public sector (including the local governments) uses cash accounting, while the enterprise sector uses accrual accounting. Moldova does not yet have a unified accounting plan for the public sector. Currently, the public sector is using about six accounting plans, which makes aggregation very difficult, and leaves room for inaccurate data in the reporting forms. There are strong expectations that this situation will change over the following years; there are also plans for Moldova to adopt modified accrual accounting in the public sector.

As per the Accounting Law, all corporate entities apply the National Accounting Standards as issued by the Ministry of Finance. State enterprises are not subject to particular regulation regarding financial reporting or audit; state enterprises may be established as stock companies or state enterprises (where the state owns 100 percent of the capital). Therefore, local utilities are to be subject to the law on stock companies with respect to financial reporting requirements. The financial reports, however, are

not public. Transparency is lacking when it comes to most state enterprises' financial position.

Institutional Issues

According to the Constitution, the Court of Accounts “controls the formation, administration, and use of public finances.” This is the only form of external audit for local government units (LGUs). The law empowers the Court of Accounts to audit the financial affairs of local governments. Such audit is not limited to State Budget transfers, but covers all municipal finances.

Under the terms of the law, the Court of Accounts is required to determine whether:

- the accounts are exact and true;
- revenues have been legally established and collected;
- expenditures have been properly made and recorded;
- subsidies and grants for investments were properly granted and used;
- state loans were properly contracted and used;
- authorized debts were justified.

The Court of Accounts audits the LGUs' accounts (at *raion* level) annually.

The Court of Accounts report is subject to parliamentary review and approval. LGUs have access to these reports only to solicit comment and answer future questions. The reports are not public. The Court of Account only publishes a synthesis of such reports for the purpose of informing the public with regard to its activity.

The Role of the Association of Audit Companies (AFAM) and the Association of Professional Accountants and Auditors (ACAP)

The profession of public accounting is developing in Moldova, and the practice of audit needs continuous efforts to be brought up to international standards. Audit activities started to develop during the second half of the 1990s; as the legislation did not provide for statutory audit, and the foreign-capital inflows were at a rather modest level, the demand for audit and related services was low. Regarding local governments and local utilities, none are required by law to hire an independent audit; only those LGUs and local utilities that are part of International Finance Institutions Programs have been audited. The World Bank and the European Bank for Reconstruction and Development

are implementing lending programs in the water sector. Under these projects, the water companies are the borrower and the LGUs act as the guarantors. According to the lending agreements, the LGUs and the water companies have to hire an independent audit to annually report on the project accounts, as well as the water companies, LGUs' records, accounts, and financial statements (balance sheets, statements of income and expenses, and related statements).⁴

The Association of Professional Accountants and Auditors (ACAP), is a nonprofit organization established in 1996, and includes about 500 members. Another organization in the field is the Association of Audit companies (AFAM) made up of 30 local audit companies. The ACAP and the AFAM do not fully cooperate with each other. The ACAP appears to be more involved in the process of the new law on accounting approval. Neither of them currently undertake a monitoring role, nor are they involved in the development of accounting standards.

The ACAP has undertaken consistent efforts to promote sound audit practices by encouraging its members to obtain certification from international organizations and finally requiring such certification for its members that are active as auditors. The ACAP's members must have at least three years' professional experience, and pass an examination based on standards agreed at the level of the CIS. ACAP members are encouraged to obtain a certificate from the Professional Accountant Program, a program established by USAID in 2001, in cooperation with international standards experts and various accounting organizations. The ACAP has made a great contribution to the audit and accounting standards' dissemination among its members through various training programs. The ACAP became a member of the International Federation of Accountants (IFAC) in 1998.

The AFAM is an organization of the audit companies established as a trade union. The AFAM is recognized as an organization with many responsibilities, including the coordination of the audit companies' activities, representing their professional interests, collaboration with other similar foreign organizations, and participation to the elaboration of audit standards. The AFAM is also entitled to submit requests for the withdrawal of a company's license in case of misconduct. In practice, the AFAM has not yet done this. None of the Big Four is a member of AFAM.

3. AUDIT STANDARDS

Audit practice is regulated by the Law on Audit issued in 1996, but which is slated to be replaced by a new audit law. The law includes provisions regarding audit function and content, the licensing of companies and individuals, auditors' responsibilities, etc. All audit companies operating in Moldova must be licensed. The license is issued by the Chamber of License, based on a certificate obtained from the Qualification Commission

of the Ministry of Finance, the National Bank of Moldova, or the Securities Commission, depending on the sector in which the company is to operate. The new law, prepared by the Ministry of Finance, addresses the issues identified by the “Financial Sector Assessment Program Report” (FSAP), issued by the World Bank in 2003:

- The fundamental audit objectives and basic concepts, as formulated by the 1996 law, do not correspond to the International Audit Standards, the European legislation, or other best practices of audit (i.e., the audit definition does not include the concept of reasonable insurance, accuracy, or accountability).
- Articles 4 and 6 of the law deal with the auditors’ independence, professional conduct, and conflict of interest; though, the requirements seem to be general at this stage.
- The principles of the auditors’ qualifications are not properly clarified by this law; the examination regulations do not correspond to international standards in this regard.
- The law is precise in defining the auditors’ obligations, but does not offer a mechanism of monitoring the compliance of the auditors with the respective law’s provisions.

The current legislation does not provide for the financial reports’ availability to shareholders, creditors, or other interested parties. The Statistics Department, however, does receive copies of all financial reports of the companies operating in Moldova, for the purpose of compiling national statistics, but is forbidden by law to make public these individual financial reports. Financial reports prepared by the local governments are submitted periodically to the MoF, but are not for public use either. Therefore, there is but a limited transparency in the corporate sector and non-existent transparency in the local government sector. Creditors and investors may have access to financial information with regard to the companies they are developing client operations with; otherwise access to such data is extremely limited. As for the local governments, it is even more difficult, because the LGUs have their current accounts with the State Treasury only. This is a major impediment in the development of the credit market and the investment attraction, and in determining the increase in the cost of capital.

The audit market is divided into two clearly distinctive segments: one for the statutory audit involving domestic companies, and another for bank audit and the audit of companies listed on stock exchange or companies having foreign capital involving local branches of the Big Four. Currently, there are 117 audit companies and individual auditors. Six large audit companies include about one-quarter of the number of licensed auditors. Currently, there does not appear to be a shortage of qualified auditors.

4. AUDIT REPORTS

Internal Audit

The internal audit function is currently missing at the local government level. The draft law on local public administration provides that the local governments should organize a department responsible for internal audit. Based on this provision, several local governments have begun to organize such functions, though they are now waiting for the MoF to issue additional regulations.

The MoF envisaged having such regulations issued in 2008. It is also under the process of setting up this function at the level of the ministries; most likely, all the implications of such a function are not yet clear to them, and a trial period is probably expected to clarify all remaining questions.

5. HUMAN RESOURCES DEVELOPMENT

A professional examination required for the auditor-certificate release does not correspond to the educational standard as per the IFAC. The examination is organized under a Qualification Commission appointed by the MoF. The examination is either written or verbal, at the candidate's choice. The questions cover various subjects, such as legislation, regulations, accounting and reporting, audit, taxation, and financial analysis.

The examination appears to be academic and focused on theoretical knowledge rather than the practical issues implied by the audit profession and theory application in real practice. This is somehow different than the international standard of the IFAC, which requires the examination to be focused on "practical abilities." The examination results are not a sufficient proof that the persons who have obtained the certificate have demonstrated professional abilities and values required for compliance with the independent-auditor specific functions.

Various factors hamper an auditor's accountability towards an interested party. First of all, the information being audited is rarely available to the public. This diminishes the capacity of interested parties to hold the auditor accountable should the activities have not been conducted according to audit or ethical standards.

Additionally, the auditors are not obligated to have professional insurance. Furthermore, under the current law, there is no monitoring system in place of the audit companies and/or individuals; this issue is about to be resolved, as the new audit law will enter into force. As neither professional organizations nor national authorities consistently monitor the auditors' performance, a low level of accountability results. Therefore, the quality of audit practice in Moldova is not very high.

The Academy of Economic Studies provides curricula for accounting and audit; while the accounting curricula seems to be well developed, the audit curricula needs to be strengthened. The interviewed audit company (one of the Big Four) noted that there is high potential to find a degree holder with solid accounting knowledge, but more difficult to find one with a good background in audit.

Local audit companies that are members of international audit organizations require their employees to have the certification from the ACCA (an organization from the United Kingdom), and are providing continuous formation of their employees. This is, however, not happening in all audit companies, though the ACAP is undertaking a large effort to cover the continuous formation role for most of the independent auditors (members of ACAP).

6. CONCLUSIONS

All the areas analyzed in this report are currently undergoing reform. Technical assistance is being mobilized by international and bilateral donors to bring Moldova's audit standards up to internationally acceptable ones. The legislative changes are envisaging private and public sectors in regards to accounting (mostly public sector, unifying the accounting system, and gradually switching to a modified accrual-accounting system), auditing (both public and private sector, regarding standards and institutional enhancement), and financial control (improving standards of internal control in public sector).

Under these circumstances, it is difficult to formulate additional recommendations. On one hand, we need to see how the reform is ultimately formulated into enforceable laws; on the other hand, there is also a need for a trial period to see how such laws are implemented, because countries like Moldova usually face difficulties during the implementation phase.

APPENDIX

List of Persons Interviewed

- **ACAP**
Marina Selaru, *Executive Director*
- **Chisinau Municipality**
Dorin Chirtoaca, *Mayor*
Tatiana Cunetchi, *Economic Director*
- **Court of Accounts**
Elisabeta Foca, *Vice-president*
- **Ministry of Finance**
Ion Borta, *General Director, Audit and Financial Control Department*
Lidia Jandac, *Head of Internal Audit Department*
- **KPMG**
Nicoleta Rus, *Audit Department Director*
- **USAID**
Andrew Popelka, *Chief of Party, Local Government Reform Project*
- **World Bank**
Andrei Busuioc, *Consultant, Public Sector and Institutional Reforms*

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NOTES

- ¹ Average flow of funds from citizens working abroad is estimated to about USD 460 million to USD one billion.
- ² Law 910-XIII of July 1996, as amended in 2000 and 2002.
- ³ Law 426-XIII of April 1995. The law was not substantially modified since its adoption. At the time of writing In 2007, a new accounting law was to be passed by the Parliament and enter into effect as of January 1, 2008.
- ⁴ The World Bank project includes three LGUs and water companies: Cahul, Orhei, and Soroca and surrounding rural areas. The EBRD project deals with the Chisinau Municipality and Water Company.

Audit Function Survey Montenegro

Jadranka Kaludjerovic

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1. INTRODUCTION

The basic goal of this analysis is to give an overview of the way in which audit of local governments in Montenegro is carried out. Namely, with the reform of the former-socialist countries and their transformation into modern market economies, the strengthening of the audit function on all levels is widely recognized as an important prerequisite for the proper functioning of the economy. This has been acknowledged in Montenegro as well. This is, however, a very complex task for it involves the time-consuming processes of creating stable institutions, upgrading the knowledge of the auditors, and generating adequate conditions for the smooth functioning of the audit system.

From the point of view of audit of local governments, relevant laws in Montenegro are: the Law on Accounting and Audit, the Law on State Audit Institution and the Law on Local Governments Financing. Generally, these laws regulate this area in accordance with the current practice in place both in EU countries and around the region. Montenegro's prospective membership in the EU, however, requires their full alignment with international practice, which means that Montenegrin legislation in this area must be improved. But the most important issue is their full implementation in the practice and avoidance of the laws' misinterpretations and misuse. In addition, in the near future, there might be an adoption of some new relevant laws, amendments, and sub-legal acts, all with the view to provide incentives and push all stakeholders to be involved in the audit process.

Beside the adoption of important laws, since 2004 Montenegro has taken strides towards enhancing and strengthening control and supervision of the way in which public money is spent. The establishment of the State Audit Institution (SAI) as a supreme control body was a crucial starting point in creating a good basis for the audit process in Montenegro. The aim of its establishment was to introduce a completely new body in the financial, legal, and parliamentary system in Montenegro. As in other countries, the SAI became the operative body performing parliamentary/political control of the spending of budgetary resources and management of the state property. In accordance with the law, at least once annually, the SAI is obliged to audit the annual budget balance sheet of the Republic of Montenegro. Since its establishment, the SAI has audited the following bodies: the budget of the Republic of Montenegro (two years in a row), the budgets of the municipality of Nikšić (for 2004) and the municipality of Danilovgrad (for 2005). During 2007, other than the State Budget, SAI audited the budget of the Health and Insurance Fund as well as the budgets of the municipalities Ulcinj and Kolašin (for 2006). The SAI informs the Parliament of the Republic of Montenegro about the audit results by submitting an annual report.

With the establishment of the SAI, audit function significantly improved and aligned with international practice (e.g., getting reports on time is now much easier). However, despite many improvements, the SAI is only in the early stages of meeting INTOSAI

and EU good practice auditing standards. It will take some years before the SAI will be in a position to undertake the full range of audits envisaged in the legislation, and to take an active part in the discussion of the execution of the State Budget. Since its inception, the SAI cooperated well with the Montenegrin Parliament and its Committee for Economy, Finance, and Budget with the view of strengthening the control function of the Parliament in the area of the public-money consumption, application of international audit standards in public sector, and education of the personnel within the SAI. In August 2004, the Parliament of the Republic of Montenegro appointed the president and members of the Senate of the SAI, which then created all the formal and legal conditions for the start of the institution's work.

The upcoming years should be ones of the continuous training, professional seminars, and lectures in the field of budget and budget control for SAI personnel. In the context of practical training, it is especially important to cooperate with the Audit Courts and other audit institutions in the region. The current number of state auditors in the SAI is 12. The SAI auditors each have the relevant background for regularity carrying out audits, i.e., tax administration and economy, and a few are certified accountants from the commercial sector. However, according to the *Internal Rules of Procedure*, the SAI is expected to have 24 state auditors. Thus, the main problem we identified is the lack of proper human resources, in terms of quantity. Much must still be done to meet this requirement.

2. LEGAL INFRASTRUCTURE ANALYSIS

The existence of good legislation is a basic prerequisite for the proper functioning of all society's aspects. An important step forward, however, is the full implementation of legal solutions. Very often, laws are not put into the practice, for manifold reasons. In order to make them work in practice, decision-makers must take into account the basic features and characteristics of the society to which they serve. Regarding the audit of local self-governments, the basic relevant laws are the following: the Law on Accounting and Audit, the Law on State Audit Institution, and the Local Government Financing Law.

2.1 Law on Accounting and Audit

The Law on Accounting and Audit organizes conditions and manners of business books' maintenance, the composition of and presentation of financial reports, and the conditions and manners of conducting the auditing process. This law applies to all legal entities registered for this type of activity, though it is not applicable to subjects financed from

budget or extrabudgetary funds. The law was declared on November 15, 2005. This law has been effective since November 26, 2005, excluding Article 15, point two,¹ which has been effective since April 15, 2006. The law is in accordance with relevant international standards such as IAS (International Accounting Standards), ISA (International Standards of Auditing), IFRS (International Financial Reporting Standards), and ICEPA (International Code of Ethics for Professional Accountants).

The basic provisions, explanation, and adjustment of certain expert terminology are explained in the first chapter of the law. The following chapter on *Financial Statements and Standards* deals with adjustment to all necessary international standards, and prescribes how to conduct, audit, and present financial reports. The third chapter on *Accounting and Bookkeeping* prescribes how to maintain business books, when to use the principle of invoice realization and the principle of cash realization, certification of accountings, and other relevant issues for this part of the law. Article 2, as a part of chapter one, gives definitions of important terms. Two of these are quite important: the Principle of Cash Realization, and the Principle of Invoice Realization. The first principle is defined as an accounting base in which transactions are ascertained in the reporting period in which they have occurred. The second principle is defined as an accounting method in which transactions are ascertained in the period in which money and money-equivalents have been paid or received, regardless of when they occurred. The financial result, according to this principle, is determined as the difference between money inflow and outflow. In chapter three, Article 4 prescribes that business books (diary, main book, and additional evidence) are maintained based on a double-accounting basis. In the same chapter, Article 5 prescribes usage of the two realization principles. The *principle of cash realization* is being used by legal entities that have an annual income lower than EUR 500,000; while legal entities with annual income higher than that have to apply the principle of invoice realization. In Article 6, point 1, the law obliges legal entities to prepare financial reports with the balance on December 31 of the business year, and to deliver the same to the commercial court by June 30 of following year for the previous one. Point 3 of the same article obliges legal entities to prepare and deliver financial reports for the financial year and for even shorter periods on the request of state agencies and organizations.

In Article 9, the law predicts the necessity of delivering financial reports in hard copy on request of state agencies. This article doesn't provide the possibility of delivering such reports in electronic form. This raises the question as to why, especially when law on electronic signature has already been enacted.

Article 10 (point 1) prescribes the obligation to keep annual wage accounts or original payment lists, with no time limit. The same article, in point 2, prescribes that the financial statements' (annual accounts'), main book and diary must be kept for at least 10 years, while attendant books and financial statements for shorter periods must be kept for at least five years. On the other hand this article comprehends even point

3 which is about keeping business info there is abstruseness regarding keeping sale and control blocks. This line requires keeping these blocks for at least three years. However, this may prove to be demanding for retailers, catering, and similar services.

Article 11 prescribes that an authorized professional accountant may become a certified accountant if he or she passes certain exams determined by the proper body, according to the IFAC training standards.

Article 12, point 1, defines “audit” as an investigation of financial reports, regarding property, capital and balance of obligations, as well as business results (applying the International Standards of Auditing and International Code of Ethics), with the aim of giving an opinion about their sincerity and fairness. When it comes to the necessity of audit, Article 12, point 2, states that it is obligatory for the INC but also for the LLC if they meet following criteria:

- Total resources above EUR 2 million,
- Annual income above EUR 4 million,
- The average number of employees is above 50 during the business year.

The question is: why is it obligatory when it comes to LLCs? These legal entities aren’t public and don’t affect public issues. They can also be managed under the provisions of criminal law. This isn’t the fault of this law, which was drafted according to the international standards. This is more of a moral and ethical question concerning private entrepreneurship and property rights. When it comes to the state companies, they should fall under this provision, though they are, or at least should be, under provision of the Law on State Audit Institution.

Point 3 of the same article prescribes audit as being mandatory for insurance companies and other financial institutions, the Central Deposit Agency, authorized participants of the capitals market, investment funds, and other collective investment schemes. This also goes for INCs as per point 2 of the article.

Article 13 prescribes who shall conduct the audit. The auditor can hire external help under the condition that those companies that are conducting the audit process are under the auditor’s supervision. This article states who is ineligible to conduct the audit, as follows:

- shareholders, members, or founders of any legal entity from Article 12, point 2 (INC and LLCs) that is the object of revision;
- any entity which conducts accounting and counseling affairs to the legal entity that is under audit;
- other cases as determined by Code of Ethics.

Article 14 deals with the issuing of license to the auditor. The auditor needs to adhere to the following criteria:

- he/she is already a certified accountant;
- they have been conducting auditing of INCs and LLCs for at least 24 months under supervision of an auditor;
- they haven't been convicted for any charge that makes him or her ineligible for conducting accounting and auditing affairs.

The audit company has to have at least one auditor employed full-time, in order to be successfully established. Article 15, point 2 is about mandatory insurance regarding possible damage that the auditor or auditing company may introduce to the legal entity which is under the audit process. The same article, however, states that insurance sums are under the competent state agency. It is important to explain the criteria upon which these sums can be established, and which is competent body (is it the State Audit Institution, Ministry of Finance, or another). Article 18 also identifies the competent organ relating to the surveillance of this law's enactment. In the same article, there is a provision about the possible transfer of this law's enactment to the professional organization. Although this is a good idea, and may be more efficient and economical, there must be some kind of identification of which kind of companies might be considered as "professional organizations."

Overall, this law offers good solutions which are in accordance with international standards. Certain issues are not defined by the law, but by the sub-regulations, which may cause difficulties in their interpretation.

2.2 Law on State Audit Institution

The Law on State Audit Institutions establishes this institution, its rights, obligations, and manners of activity. The institution has been imagined as an independent state organ; and there is a provision that no one may influence any senate member of the institute.

This law was declared by an act of the President of Republic of Montenegro, on April 26, 2004. Previously, it was adopted by Parliament on April 21, 2004. The Law on State Audit Institution was enacted on May 9, 2004, eight days after its publication in the *Official Gazette of the Republic of Montenegro*. It points out the establishment of the State Audit Institution (SAI) as an independent state organ and legal entity with the implementation of this law's provisions as its main activity. The SAI must also interrogate legality, efficiency, and effectiveness criteria during the auditing process. The legal portion defines the control of the adjustment of business activities with the provisions

and general standards in public revenue collection, expenditure financing, property disposal and maintenance, obligation execution, and economic-affairs management. The “effectiveness criteria” address the degree to which planned goals were fulfilled; while the “efficiency criteria” is more oriented towards controlling whether these goals have been realized with minimal resource investment.

The Law on State Audit Institution states subjects of revision (Article 4) under this law. These are bodies’ and organizations’ managing-budget, and state’s and local municipalities’ property, extrabudgetary funds, in addition to the Central Bank and other entities in which the state has partial ownership (public companies at the local level). The SAI also conducts audit of subjects who are executing the budget, managing state property, and receiving donations, or irretrievable sources/guarantees apropos doing business with the subject of revision. It is important to separate different subjects’ audits from the aspects of regularity, effectiveness, and efficiency. This is an important issue because it isn’t the same to conduct an audit of a local municipality and utility company, for example. This is especially important when it comes to the effectiveness and efficiency criteria.

Article 11 states that data and findings from the audit process have a confidential character unless the law states differently. Article 15 also discusses premature public disclosure, but only in the sense of informing Parliament or government if there is a potentially harmful consequence. The transparency of the audit process is precondition for the increase of faith in state institutions.

It is important that this law takes into account the rights of third parties (Article 17), third parties being defined as entities which are in business relation with the audit subject.

Article 22 continues of provision of Article 12, which states that the audit report must consist of factual data, remarks, conclusions, and suggestions for the rejection of certain short-comings. Regarding Article 22, the damage of state property constitutes the basis for state-attorney actions towards the damage-refund process. But some of these articles should also include a damage-refund demand process regarding private property committed by actions of a state body. If there is any doubt that some felony has been committed, the SAI is obliged to submit a penal report.

According to the Article 28, the *final account* of the SAI can be consigned to a specialist organization by Parliament. We believe this is a good approach though it not yet regularly implemented in practice.

The SAI has its own senate and collegiums. The senate has three members. Each member is in charge of certain sectors within SAI. Each senate member has to be a citizen of Montenegro with degree (B.A.) in law or economics. Besides these general conditions, potential member of the SAI Senate must have passed a jurisdiction exam and have 10 years of working experience in the legal profession. Additionally, they need to have passed an expert exam qualifying them for the profession of auditor or accountant, and

at least 10 years of work experience. Among the three members, two must have at least a B.A. in law and one in economics. Senate members are nominated and chosen by Parliament after the proposal of the jurisdictional operating body. The president of the SAI is chosen from the senate members, and has a nine-year mandate, and cannot be re-elected. Regarding operational arm of the SAI, the manner of choosing members, the president, is questionable. Member of the SAI's senate have permanent membership, unless they request re-assignment, are ready to retire, or has been convicted of a relevant crime. First of all, we believe that competition among potential members could improve the efficiency of their work. Also, measures towards those who have criminal records should be further strengthened. .

Provisions related to internal organization, prohibitions for senate members, and proposed reports are in accordance with international practice. They are obliged to keep information and data confidential regardless of how it was revealed (Article 42).

Articles 45 introduces the function of state auditor. All provisions of this article are appropriate and in accordance with international standards. When necessary, Article 46 enables the engagement of an external expert for the audit. Conditions an external auditor's engagement aren't part of the law; they are prescribed by the SAI's own documents.

Penalty issues, which are covered by Part Six (Articles 52 to 54), are also quite appropriate, and discuss the penalties for the auditing subject, excluding one related to confidential data's premature disclosure. All sides in this process should be equal; auditor and audit subject, especially regarding responsibilities and consequences.

In general, this law is appropriate for this stage of the SAI introduction process, though it could be improved upon. Improvements should be oriented towards achieving a higher public profile, the disclosure of data, increased vigilance over taxpayers' money, and the elimination of possible discretionary decisions.

2.3 Local Government Financing Law

The Local Government Financing Law was adopted in July 2004. According to this law, municipalities receive a high degree of autonomy in conducting fiscal policy on their territory and under their jurisdiction. This is in line with the overall trend towards decentralization, and especially fiscal decentralization, which is a precondition for the competitive advantage of municipalities and/or states. The Local Government Finance Law left broad powers to the municipalities regarding tax collection, various tax introductions, and the amount of those taxes. Nevertheless, just in the few first months of its implementation, companies in Montenegro faced serious problems pertaining to the increased fiscal burden on the local level. The idea, therefore, has had some unexpected consequences.

Today's practice in Montenegro is that although at the central level there is a tendency towards tax- and administrative-burden decrease, on the local level it is reversed. Only time will tell what sort of consequences this will have on economic development and growth.

2.3.1 Municipal Revenue Review According to the Local Government Finance Law

According to this law, the revenues of municipalities are divided between *own resources* and *common revenues*. *Own resources* are revenues that are introduced according to the law by the municipality, along with any self-contribution which can be introduced by the municipality in order to solve certain local problems. But that can be an obstacle for businesses and citizens as well, and sometimes the legitimacy of those decisions can be raised for discussion. They are comprised of the following:

- 1) municipal tax,²
- 2) inheritance and gift taxes,
- 3) hazard and entertainment taxes,
- 4) residence tax,
- 5) local administrative tax,
- 6) local communal tax,
- 7) contribution for structural land use and contribution for structural land array,
- 8) contribution for protection of the environment,
- 9) revenues from municipal properties and revenues from property rights,
- 10) revenues from companies and other legal entities belonging to the municipality,
- 11) fines imposed in the judiciary process as well as detracted property benefit in the same process,
- 12) utilities' concession revenues,
- 13) revenues of municipality services, organizations, and agencies,
- 14) deposit interest rates,
- 15) self-contribution revenues introduced for municipal territory,
- 16) donations and subsidies,
- 17) other revenues introduced by law.

Common revenues are tax and contributions revenues introduced by central government of which one part belongs to the municipalities. They are comprised of the following:

- 1) revenues from personal income tax (PIT),
- 2) revenues from real-estate turnover,
- 3) natural goods concession revenues on concessions given by the state.

2.3.1.1 *Municipal Taxes*

This law indicates five taxes that can be introduced by the local government within its own territory:

- 1) surtax on personal income tax,
 - 2) real estate tax,
 - 3) consumption tax,
 - 4) tax on unused structural land,
 - 5) corporate or name tax.
- *Surtax on personal income tax* can be introduced by each municipality up to 13 percent, while the former capital and any major city can introduce it up to 15 percent (the appendix contains an overview of the effective tax and surtax rates by municipality). According to the ISSP calculations, the highest effective PIT surtax rates are in Podgorica and Nikšić: 2.5 percent and 2.2 percent, respectively. Also, the highest effective tax rate is in these municipalities: 16.7 percent in Nikšić and 16.5 percent in Podgorica. The lowest effective tax rate is in Kolasin (12.5 percent), which also has the lowest effective surtax rate.
 - *Real-estate tax* is paid by legal entities and individuals as owners of real estate (land, buildings, residential and business building units, and other structures). The tax rate is proportional, and can vary from 0.08 percent to 0.80 percent of the real-estate's market value. Also, the municipality can establish different rates for different real-estate categories. Upfront common rules should be established pertaining to this tax.
 - *Consumption tax* is paid on alcohol and non-alcoholic beverages in hospitality venues. This tax is based on the retail price of the beverage that is being sold on the premises, in which value-added tax and consumption tax aren't included. The consumption-tax rate can't be higher than three percent, excluding the former capital and other major cities, where it is five percent.

- *Tax on non-building structural land* is paid by legal entities and individuals who are the owners of this land. This is defined as land within structure-inhabited areas in which construction is possible only according to a spatial plan, and only if there are not already constructed objects or temporary objects or the ruins of previous buildings on it. Tax on non-building structural land is paid annually in the range of EUR 0.03 to EUR 0.30 by square meter of non-building structural land.
- *Tax on company or name* is paid by legal entities or individuals which are tributaries of corporate tax or personal income tax, and which are registered for certain activities. This tax is paid annually and can't be more than EUR 300 for each company.

2.3.2 Recommendations for Legal Changes

- Clearly define criteria for the introduction of taxes, including the manner of their adjustment (increase).
- Define different treatment for utility companies, especially before their privatization.
- Clearly define the basis for taxes.
- Clearly point out the municipalities' jurisdiction.
- Define procedures for municipality decision-making process regarding the introduction of taxes.
- Ensure business sector involvement in the decision-making process.
- Introduce a maximum limit for all taxes (not just for infrastructure) and explain the reasons why most municipalities charge the maximum level of taxes.
- Define procedures for the market-value estimate of facilities.
- Minimize possibilities for different interpretations of the law.
- Consider necessity of the consumption tax, considering that it represents double taxation.
- Consider the necessity of non-building structural land tax.
- Precisely define company tax apropos of the term "company" in order to guard against different interpretations.
- Revise and make provisions about *incentive donations* and their effect on the municipalities more precise (these donations shouldn't be for tax-progressive municipalities).
- The current budget reserve is not defined.

3. CURRENT PRACTICE IN MONTENEGRO

In order to accurately analyze the way in which audit processes are carried out in Montenegro, in addition to the analysis of the relevant laws in this field, the ISSP conducted three interviews with experts. The interviews were conducted with the representatives of the following institutions: State Audit Institution (SAI), the municipality of Bar, and MARMIL (a private company at which there is ongoing training for accountants in Montenegro). These interviews were of great importance for the statements incorporated within this report. There was also an attempt by the ISSP to conduct an interview with one of the members of Parliament's Committee for Economy, *and* Finance and Budget. Unfortunately, during the period of the realization of the project, Parliament was in session daily.

3.1 State Audit Institution (SAI)

In Montenegro, the supreme control organ engaged in audit of the State Budget, extra-budgetary funds, local self-governments, the Central Bank of Montenegro, and other legal entities in which the state holds a share, is the State Audit Institution (SAI). The SAI chapter of Montenegro was established in April 2004 (by the Decree on Promulgation of the Law on the State Audit Institution No. 01/625/2). The SAI is an institutional, external, independent, professional, and impartial control of the budget expenditures and state property management of Montenegro. The institution independently determines the audit entities, content, volume, and audit type. The SAI functions in accordance with the *Lima Declaration Guidelines*, which were adopted in October 1977, at the IX INTOSAI³ Conference in Lima (Peru), as the principal international document on the legal organization, position, and activities of the public sector audit. The basic principles incorporated in SAI activities are the following: implementing INTOSAI audit standards, independence, competence, special attention, and other general standards of the SAI.

The aim of the SAI's establishment was the introduction of a completely new body to the financial, legal, and parliamentary system in Montenegro. As in the other countries, the SAI became the operative body performing the parliamentary/political control of the spending of budgetary resources and management of state property. Namely, according to the modern budgetary theory and practice, the budgetary control performed by the Parliament cannot be real, accurate, and efficient, as long as there is no institutional, independent, and professional control that will regularly submit relevant reports and be responsible for their own activities to the Parliament. Only after checks and regular reporting of the SAI will Parliament be able to qualitatively and successfully perform the role of the highest body in the system of the political-budgetary control. In this way, Montenegrin taxpayers will be timely and accurately informed about the spending of public money.

As stated, the SAI controls the regularity, thrift, efficacy, and efficiency of budget expenditures and the state property management. In addition to its control and advisory function, the SAI also conducts administrative activities. The following internal acts of the institution were adopted: Internal Rules of Proceeding, Working Methodology Instructions (*Official Gazette of the Republic of Montenegro*, February 2005) and the Rules of Work Organization and Job Organizational Chart. In the future, the SAI plans on enhancing its advisory role. This is due to the fact that in every modern state, the adoption of the strategic decisions in the field of public finances must be supported by the objective and qualified opinion of the SAI.

In accordance with the Law on SAI, Article 9, the institution is obliged to audit the annual budget balance sheet of the Republic of Montenegro at least once during the year. Since its establishment, the SAI has audited the following bodies: the Budget of the Republic of Montenegro (for two years in the row), the budgets of the municipalities Nikšić (2004) and Danilovgrad (2005). During 2007, other than the State Budget, the SAI audited the budget of the Health and Insurance Fund, and the budgets of the municipalities Ulcinj and Kolašin (2006).

The SAI informs the Parliament of the Republic of Montenegro of the audit results by submitting an annual report. The annual report must be presented to the Parliament by the end of October.

In accordance with Article 30 from the *Internal Rules of Proceeding*, the SAI informs the public about its activities. Notice is made via institution reports (Annual Reports and the Special Reports) and website of the institution. It also can be made public through press releases, press conferences, and interviews, etc. A state auditor cannot publicly present data and knowledge he/she arrived at during the course of the audit process. The SAI is obliged to make available information and present documentation for inspection on request of the state prosecutor. This decision is made by the senate of the SAI.

Since its inception, the SAI established very good cooperation with the Montenegrin Parliament and its Committee for Economy, Finance, and Budget, all with the view of strengthening the control function of the Parliament in the area of public-money consumption, application of international audit standards in public sector, and the education of the personnel in the SAI. In August 2004, the Parliament of the Republic of Montenegro appointed the president and members of the senate of the SAI, thus creating all the formal and legal conditions for the inception of the institution.⁴

It may be concluded, that with the establishment of the SAI, audit function significantly improved and aligned with international practice (for example, getting reports on time now is much easier). However, despite many improvements, the SAI is still in the early stages of meeting the *INTOSAI* and EU good practice auditing standards. It will take some years before the SAI will be in a position to undertake the full range of

audits envisaged in the legislation, as well as take active part in the discussion of the execution of the State Budget.

3.1.1 Senate of the SAI

As already mentioned, members of the senate are appointed or relieved from duty by the Parliament.⁵

In accordance with the Internal Rules of Proceeding (*Official Gazette of the Republic of Montenegro*, No. 02/05 from January 18, 2005), Article 5, the senate of SAI, aside from the activities determined by the law, also:

- determines strategy and guidelines for audit;
- adopts decisions on audit not covered by the Annual Agenda;
- makes decisions about the appointment of an external expert in circumstances that require specialist knowledge;
- determines the proposal of the budgetary resources for the institution;
- takes care of the implementation of the uniform criteria for audit, and the decision-making processes;
- other activities determined by the *Internal Rules of Proceeding*.

Beside activities determined by the law, the *president of the senate*:

- determines the schedule of activities in collaboration with the members of the senate;
- establishes cooperation with state institutions in Montenegro, audit institutions from abroad, and international associations;
- proposes specific audits;
- informs the Parliament of Montenegro about the appointment or dismissal from duty of the members of senate;
- puts together drafts of the Annual Audit Agenda, as submitted by the collegiate bodies;
- puts together proposals of the drafts of the collegiate bodies for Annual Reports;
- other activities determined by the *Internal Rules of Proceeding*.

Each November, the president of the senate defines the Annual Audit Agenda for the next year by arrangement with members of the senate. This agenda is adopted by

January 10 of the upcoming year. A description of the each specific audit anticipated under the *Annual Audit Agenda* is comprised of the following:

- 1) the subject of the audit,
- 2) object of the audit,
- 3) assumed duration of the audit process.

3.2 Audit of Local Governments in Montenegro

In accordance with Article 4 of the Law on State Audit Institution (*Official Gazette*, No. 28/04 and 27/06) and Article 55, point 10 of the Law on Financing of Local Governments (*Official Gazette*, No. 42/03 and 44/03) as well as the audit standards of INTOSAI, the SAI should audit budgets of the local governments for the fiscal year in question. The law prescribes that local governments are subject to the following:

(1) *audit of legality*

This identifies the current legal rules and regulations (laws and sub-legal enactments) and international standards in the area of public finances obeyed and put into practice in the field of management of budget, state assets, and economic affairs. It also encompasses verification of the accuracy in accounting, book-keeping, recording of public revenues, and expenditures.

(2) *audit of final account (financial audit)*

This is aimed at verifying accuracy of the data presented in the Final Account of specific municipality.

(3) *audit of efficiency in management of budget, assets, and economic affairs (performances audit)*

The basic goal of this kind of audit activity is to compare actual outcomes with the planned targets. This criteria is also comprised of a *control of good results* (control of the scope in which state activities are appropriate and successfully performed) and a *control of efficiency* (the investment of minimum of resources in order to attain the goal). In a word, *audit of efficiency* verifies that the maximum of results are reached, and determines whether the goals and objectives have been attained with the minimum use of budgetary resources.

According to the law, there are five levels of audit of local governments:

(1) *general audit*

General audit represents a comprehensive overview of the financial management of the subject of audit.

(2) *selective audit*

Selective audit analyzes a specific period of time or a limited subject of audit in terms of scope.

(3) *audit of intersection*

Audit of intersection examines a representative group of subjects of audit, all with the view to reach some useful evidence related to the specific area of state administration.

(4) *preliminary audit*

Preliminary audit (audit overview) is intended to give an overview in certain areas, procedures, or events, in order to prepare a basis for the future audits.

(5) *subsequent audit*

Control audit serves as a tool that defines the scope in which subjects of audit respected the previous findings of auditors.

The audit of local governments is in-depth rather than limited to the concept of “own resources” or “transfers from central budget.” In common Montenegrin practice, the object of the audit is the *Final Account* of the municipality, comprising the following financial statements:

- 1) Balance Sheet,
- 2) Cash-flow Statement,
- 3) Statement on the budget’s execution (showing the difference between commitments appropriations and payments),
- 4) Statement on Grants and Repayment of Foreign Debt,
- 5) Statement on the Use of Permanent and Current Budget Reserves,
- 6) Statement on the Given Guarantees,
- 7) Explanation of the Gaps between Commitments, Appropriations, and Payments.

3.2.1 Process of Audit of Local Governments in Montenegro

Since its establishment, the SAI has only audited budgets of two municipalities (Nikšić in 2004 and Danilovgrad in 2005), out of 21 municipalities that operate in Montenegro. The lack of a sufficient number of proper human resources made it impossible to audit all local governments. It has proved difficult for the SAI to increase staff resources, as there are not enough funds to enable the institution to fill its vacant posts. Despite this, members of the senate of the SAI are optimistic about the future, as they believe that they will succeed in generating a sufficient number of quality auditors, who will be qualified to cover this complex task.⁶

In accordance with the rules regulating activities of the SAI, authorities of these two municipalities were informed at least 14 days before the audit activity was to start.⁷ After the fieldwork ended, the results were verbally discussed with the subject of the audit, along with other relevant topics (those that assisted in data collection) SAI deemed necessary. However, the President of the Republic, the President of Parliament, and the Prime Minister are also to be informed of circumstances of a confidential nature.⁸ The purpose of this verbal notification was to inform the subject of the audit about findings, realization, and the opinion of the state auditor in the very first phase, and to explain the continuation of the audit process. The time left to the subject of the audit to express his or her own views was 30 days.

After an audit is completed, the state auditor draws up a draft of Records on Audit, that includes the object of audit, course, and the result of the examination. Each state auditor is responsible for their own part. A “Records on Audit” is composed of: Minutes on Audit (internal act), Report on Audit (external act), and a Letter on Audit.

After the final decision about the results of the audit was made, the collegiate body informed the subjects of the audit of its completion. The subjects of the audit were also informed of the Report Institution’s intent to submit further the results (to the Parliament and government), all in accordance with Article 18 of the Law on SAI. The Annual Reports for these two municipalities that the SAI submitted to Parliament and to the government by the end of October of the year following the one covered by the audit (Article 19 of Law on State Audit Institution). These bodies gave their positive opinion and adopted submitted reports. Finally, these reports were published on the website of the SAI, which makes them public to all interested parties, including local councils, local media, and civil society.

The SAI audited the Final Accounts of the municipalities Nikšić and Danilovgrad in accordance with the International Auditing Standards (INTOSAI). They allowed the institution to make certain that the Final Accounts document did not contain any errors. With the application of INTOSAI, all audit processes were qualitative, economical, efficient, and completed on time. The entire audit process covered the following: evaluation of the organization, system of internal controls, assessment of

assets and financial conditions, a check of the financing sources, financial execution of the municipalities' budgets, as well as financial transactions and their coverage with proper documentation.⁹

The main goal of the executed audits was the examination of the legality of payments and spending of budgetary resources. In other words, financial audit was carried out via:

- control of the extent to which rules related to the public expenditures, and public revenues and all varieties of liabilities were obeyed;
- control of the extent to which the legal rules related to the management of assets and economic tasks were obeyed.

Box 1.

Annual Audit Reports for the Municipalities of Nikšić and Danilovgrad

The Annual Audit Reports on the audits of these two local governments include an overview of the SAI's findings on the budget and state property and their causes and consequences, as well as suggestions for improvement. They consist of results of relevant audits' evaluation of legality, effectiveness, and efficiency of their subjects' activities. The *Audit Report* includes real facts, their evaluation, conclusions, and recommendations aimed at removing shortcomings. Reports on the audit of the "Final Account" of both municipalities comprise: (1) an overview of the basic activities carried out in these municipalities during the fiscal year, (2) results of the audit, and (3) conclusions and recommendations for the perspective period. The primary goal of the state auditors in these two municipalities was to verify that the data submitted in the *draft on the Final Account* for both local governments was accurate and whether the international accounting standards for the public sector were applied and legal rules and regulations obeyed.

The ultimate conclusion of the SAI was that *drafts of the Final Account* of both municipalities could be accepted because they give an accurate overview of the budget revenues and expenditures. The SAI reported that the *Final Accounts* of these two municipalities were prepared in accordance with the legal rules and regulations managing the area of public revenues and expenditures and all other provisions that are relevant for the preparation of the *Final Account* of the local government, were based on *cash-based* reporting. Also, they were in line with international accounting standards for the public sector.

It is important to stress that audits of the budgets of local governments pointed out some omissions and shortcomings that must be eliminated. With their elimination, and with the implementation of given recommendations, local governments will improve their business in the area of financial management and reporting. This applies especially to the recommendation of the SAI in both municipalities about the provision of reliable tax accounting, which serves to give an overview of debt servicing, and is in accordance with the Local Government Financing Law and Law on Tax Administration.

It can be concluded that although performed in only two municipalities regularity and financial audit provides an overview about the extent in which legality is obeyed in the activities of the subject of audit, as well as the level of objectivity of the figures on public revenues and expenditures in the *Final Accounts*.

3.3 Case Study—Municipality of Bar

One of the clearest provisions of the Law on the State Audit Institution is the SAI's obligation to conduct the audit of municipalities and other bodies as specified by the law. As evinced by various legal solutions, a theoretical approach within legislation is one issue, but actual, practical implementation is another. That is why we interviewed the municipality's representatives as a follow-up to common practice.

In the case of the municipality of Bar, we saw some gaps between the law on paper and the law as applied. The SAI never audited this municipality, though it was previously invited by their representatives. Representatives of this municipality were and still are very interested to have the SAI's audit report. They are even willing to pay twice the going commercial price to the SAI to be audited. The municipality of Bar is willing to be the subject of a non-prior-notice audit, but would also like to have audit at a specified time period. They would like to be audited at least once every two years.

The current administration in the municipality of enforces prescribed standards of entrepreneurship. But this administration itself also acts in an entrepreneurial manner. They have already hired different auditing houses to conduct their external audit. They have even changed auditors because previous ones weren't ready to perform external audit within a given time framework. This might seem strange, but it is true. They wanted to have their external audit before the adoption of their final budget account in the local parliament.

The administration of this municipality believes that external audit isn't expensive. The price of the external audit is acceptable even for poorer municipalities. Even if the price was higher, the administration in Bar believes it "isn't expensive" compared with its advantages and its necessity. They have recognized the importance of the audit and, therefore, they intend to conduct it before every final budget account adoption.

They have conducted each required external audit for their overall financial activities. External auditors were constantly taking care of all three areas of audit that are prescribed by the law, as an obligation of the SAI: legality, efficiency, and effectiveness.

The audit report is available to the councilors of local Parliament, along with the decision on the final budget account for that year. Members of Parliament receive a one-page report from the external auditor along with the decision. If they want to see the entire report, it is available, just as it is available upon request for all interested parties, such as media or civil society. The auditor's report will probably be posted on a website in the future, as is the case with the municipality's budget.

Public companies in this municipality are also under a commercial external-audit process. Companies like the water-supply company have already undergone it, and that report was also made available to the members of Parliament and others, upon request.

This municipality doesn't have internal auditors, though they realize the necessity for such personnel. They believe that internal audit is necessity, and are reconsidering the option of introducing internal auditors into each municipality. Furthermore, they are considering an option to perform an internal audit report with each budget's rebalance, as internal auditing should be a constant process. They believe it is possible to reduce budget expenditures on certain levels just by introducing internal audit.

4. HUMAN RESOURCES DEVELOPMENT

In Montenegro, it is a recognized fact that with the lack of a strong audit professionals, there is little investor trust in companies' financial reports. Poorly informed markets make it difficult for entities to raise capital, or they have to pay premiums for capital to compensate for the "high risk" nature of borrowing or investment in an environment where quality information is lacking. Thus, the development of the audit profession is an essential part of enabling Montenegrin companies everywhere to do business.

According to Article 14 of the Law on Accounting and Audit, audit may be performed by a qualified person provided that he/she:

- (1) is a certified accountant;
- (2) is, for at least 24 months, under the supervision of auditor-audited joint stock companies and/or limited liability companies; and
- (3) was never convicted of any criminal act that would prevent him/her from performing the activities of an auditor.

Additionally, each auditor is obliged to respect the *Code of Ethics*, which is a general code of moral values regulating the professional behavior of auditors.

In the EU, all legal entities playing the financial markets are obliged to align their financial statements with the IAS. To fulfill this requirement, each country must be upgraded with skilled accountants and auditors. Although Montenegro is not yet a full member of the EU, the nature of its legal requirements is oriented towards high-quality auditors.

4.1 Human Resources Development Activities of the Institute of Accountants and Auditors

The main body in charge of the training of auditors in Montenegro is the Institute of Accountants and Auditors. This institute is in charge of adopting national professional standards. Also, it is the primary entity that conducts the training of the auditors and accountants, and also develops the comprehensive system of control in different stages. In this area, the institute is assisted by its own members, companies, and agencies that provide accounting and audit services, as well as other associations and companies. All trainings of both auditors and accountants are based on the ACCA model. Since 2003, the Institute of Accountants and Auditors has been a member of the International Federation of Accountants (IFAC), whose basic mission is to strengthen accountants' professional profile in the world, and application of harmonized standards across countries. The IFAC adopted the International Audit Standards. Automatically, each member of the IFAC becomes a member of the International Accountant Standard Boards (IASB) that adopt the International Accounting Standards. Although Montenegro still lags behind the developed world with respect to the implementation of modern audit and accounting standards, membership in these two institutions represents a real chance to catch up. Bearing in mind that a healthy audit/accounting climate is necessary prerequisite for attracting both domestic and foreign capital, this will have wider repercussions outside of those in the audit and accounting area.

Montenegro started establishing a professional audit and accounting body with the creation of small groups of professional auditors being trained by visiting foreign auditors. The next step was initiating their financial control within businesses, be it a SME or large corporation. This immediately improved the management of those organizations' resources, corporate culture, and made them more effective.

The Montenegrin Law on Accounting and Audit envisaged direct implementation of the International Audit Standards. However, there is a long way to go until their full implementation. This means that formal promulgation of the IAS, as directly applied in current practice, is not enough. Rather, it is necessary to have their continuous systematic affirmation, thus bridging the gap with the rest of the world in this area. That is the real challenge for Institute of Accountants and Auditors.

What are the basic qualifications that auditors in Montenegro should possess? Bearing in mind that audit of local governments' budgets has to be performed in accordance with the International Audit Standards (INTOSAI), auditors in Montenegro are required to possess enough knowledge in the area of European accounting standards and modern concepts of *value for money*. There is an ongoing process of upgrading skills and knowledge of auditors within the International Audit Standards. Although, in its infancy, the main goal of all trainings, is to develop skilled auditors capable of carrying out activities in accordance with the latest standards and practices of the developed world. The lack of quality auditors results in the financial statements of Montenegrin companies not being prepared in accordance with the international standards in this area.

Box 2.

ITC System in the SAI

The SAI developed the ICT system in order to create conditions for the efficient functioning of the audit system. The ICT system enabled simpler and faster audits, data collection, data processing, data availability, the exchange of information, as well as greater security in the storage of audit information and data. In order to support that goal, the SAI implemented the software Idea of the Canadian company Caseware. Its purpose is collection, analysis, and sampling of the data that are intended for the audit. The software was financed by GTZ as a grant in kind. After that, training for the use of this software was organized for six auditors and one ICT advisor in the SAI. In the collaboration with GTZ, there is an ongoing process of purchasing of software solutions intended for the follow up of the audit process, exchange of the documentation during the audit (horizontal and vertical exchange), and the storage of data on executed audits. The ICT in the SAI is composed of: one server, 25 computers, nine printers, and network equipment. The equipment is licensed. SAI won it from GTZ as a grant in kind.

4.2 Human Resources Development Activities of the State Audit Institution

Currently, there are 12 state auditors. The SAI auditors have the relevant background for carrying out regularity audits, i.e., tax administration and economy, and a few are also certified accountants from the commercial sector. However, according to the Rules of Procedure, the SAI is expected to have 24 state auditors, which means that at the

moment, SAI employs only half the projected number of auditors. Thus, the main identifiable problem is the lack of proper human resources, not in quality but in quantity.¹⁰ With the employment of the necessary qualified staff, the SAI will be in a position to cover a broader range of audits, which includes the State Budget, three extrabudgetary funds, 21 local governments, and audit of privatizations.

State auditors in Montenegro have been trained at the Faculty of Law in Podgorica, had practical training in the Institute for Accountants and Auditors in Montenegro, and in the private companies, “Montrev” and the audit company Deloitte & Touche, where they had six-month-long trainings, in accordance with the program established by GTZ. As for practical training, of special importance were the lectures of the experts from the Audit Court and Parliament of the Germany in the field of institutional and political budgetary control (Bauer, Hof, Vonceussler, Teshner, etc.).

According to Article 45 of the Law on State Audit Institution, a *state auditor* gets his or her job on the basis of public announcement, and then he/she acquires civil-servant status. To become state auditors, the auditors must pass a general professional examination and a state auditor’s examination. Examination for the state auditor is done in accordance with the program created by the Ministry of Finance, on the proposal of the senate.

The State Audit Institution is currently carrying out activities aimed at a permanent training of state auditors and administrative staff. The main goal is to develop professional and skilled personnel for audit. During 2005, the following courses and seminars were carried out: the Seminar on Audit of Efficiency, the Seminar on Management of Documentation in SAI, a Workshop for Proper Usage of Softer for Audit (data analysis and sampling), the Seminar on Public Procurement, and a course on the use of the program Excel for all employed staff in the institution.

Programs for the continued training of personnel are accomplished in collaboration with the German Organization for Technical Cooperation. In the context of the program of the practical training of auditors, it is highly important for audit courts and audit intuitions within the region to cooperate. From September 2007, the SAI intends to organize trainings and courses for all interested people in the area of audit and accounting. These trainings and courses will be supported by a high-quality teachers, and only relevant topics will be covered.

The upcoming years should be years of the continuous training, professional seminars, and lectures in the field of budget and budget control for SAI personnel. In the context of practical training, collaboration is especially important between the Audit Courts and other audit institutions in the region. The advantages that this kind of collaboration bring are the following: knowledge of the language, shared geographic area, common historical, cultural, traditional, and other factors.

APPENDIX

Table A1.1.
Effective Tax and Surtax Rates by Municipality

Municipality	Effective surtax rate on PIT (Percent of earnings)	Effective PIT (Percent of earnings)
Andrijevisa	1.8	13.7
Bar	1.7	13.4
Berane	1.7	13.3
Bijelo Polje	1.9	14.7
Budva	1.8	14.2
Danilovgrad	1.9	14.7
Žabljak	1.9	14.5
Kolašin	1.6	12.5
Kotor	1.9	14.6
Mojkovac	1.8	13.9
Nikšić	2.2	16.7
Plav	2.0	15.2
Plužine	1.8	14.1
Pljevlja	2.0	15.0
Podgorica	2.5	16.5
Rožaje	1.8	14.2
Tivat	1.9	14.9
Ulcinj	1.7	12.9
Herceg Novi	1.9	14.4
Cetinje	2.0	13.6
Šavnik	1.9	14.6

Source: Monthly Statistical Report, Vol. 2, 2005—average earnings by municipalities in 2004.
Calculations: ISSP.

Table A1.2.
Municipality Taxes Overview, Percent

	PIT surtax rate (Percent)	Consumption tax rate (Percent)	Company tax (EUR)	Real-estate tax rate (Percent)
Andrijević	13	3		
Bar	13	3		
Berane	13	3		
Bijelo Polje	13	3		
Budva	13	3		
Danilovgrad	13	3		
Žabljak	13	3		
Kolašin	13	3		
Kotor	13	3		
Mojkovac	13	3		
Nikšić	13	3		
Plav	13	3	20–300	0.08–0.30
Plužine	13	3		
Pljevlja	13	3		
Podgorica	15	5		
Rožaje	13	3	30–300	0.08–0.30
Tivat	13	3		
Ulcinj	13	3		
Herceg Novi	15	5		
Cetinje	13	3	40–300	0.35–0.40 (individuals) 0.20–0.30 (legal entities)
Šavnik	13	3		

NOTES

- ¹ This article is addressed to an auditing company. Point two prescribes that the auditing company or the auditor include a contract about mandatory insurance for all possible damage responsibilities that might occur during its work.
- ² Municipal taxes are elaborated in more details in the following pages.
- ³ International Organization of Supreme Auditors.
- ⁴ The basic bodies within SAI are the senate and collegiate bodies.
- ⁵ For more details, see the first part of this report on legal infrastructure (*Law on SAI*).
- ⁶ The SAI may appoint external experts when its human resources are not sufficient in terms of either specialist knowledge or the quantity for the audit process.
- ⁷ In special cases, audit may begin even without previous notification.
- ⁸ The SAI should inform Parliament and the government of particularly important issues through Special Reports.
- ⁹ Audit of the matching of figures on revenues and expenditures with the proper documentation was done on the basis of a sample. The SAI places special attention on the collection of evidence (*audit of sample*) that serves as a tool of checking accuracy and objectivity of against both domestic and international accounting rules for the public sector.
- ¹⁰ The institution is allowed to appoint an external expert when its human resources are not enough in terms of special skills and number of personnel, all with the view of carrying out the audit activities in the best way (Article 46 of the Law on State Audit Institution).

Romania: Survey of Audit Function in Local Government

Andreea Năstase

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INTRODUCTION

Romania is currently undergoing a multifaceted process of decentralization, meaning the gradual transfer of responsibilities and financial resources to local governments. The success of this process requires an adequate scrutiny of local governments' financial management and, in this regard, audit function is of great importance. Any account of the audit function in the Romanian local governments must consider at least two components: *the public internal audit*, introduced by Law No. 672/2002 on the Public Internal Audit, and *the public external audit*, exercised by the country's Supreme Audit Institution, the Court of Accounts (RCOA), through its territorial structures, on the basis of Law No. 94/1992 on the Organization and Functioning of the Court of Accounts, with subsequent modifications and completions. The use of private auditing by local governments is extremely rare, and will therefore not be a focus of this study.

Recent years have witnessed significant reform in the area of public audit, largely prompted by the obligations assumed by Romania during European Union accession negotiations. Chapter 28 of the *acquis communautaire* requires, among other things, the establishment of internal public audit units in all public entities, which should be functionally independent; the existence of an independent external audit; special guarantees in regard to the management of pre-accession funds, structural funds, and other financial instruments of the EU. Romania has translated the relevant European *acquis* into domestic legislation and closed this negotiation chapter at the end of 2003. However, important problems remain as to the actual implementation of these measures, particularly at local government level.

The audit function in local government has raised little concern from Romanian policy analysts. Virtually all foreign interest has been intimately connected to the reform requirements of the EU-accession process. Now that Romania has gained EU membership, as of January 1, 2007, European pressure and monitoring have diminished, and thus, there exists a risk that reforms initiated in recent years will likewise come to a standstill, and emerging problems will be neglected. There is a pressing need for domestic and regional policy analyses regarding the audit function in local governments, which would act as a counterweight to this emerging possibility. The present study addresses this important gap by offering a comprehensive review of the legislative framework and human resources policies currently in place in Romania's public audit system.

The study is organized into two main sections, dealing with the systems of internal and external public audit, respectively. Each of these sections is further organized around a number of sub-themes, as follows:

- *the general framework for the organization of internal and external audit*, dealing with the identification of the key actors, and their attributions;

- *the remit of the audit mandate* (i.e., the type of public entities and funds/assets/transactions which are under the purview of auditors, the type of audits being performed, and the auditors' access to documents during assignments);
- *the impact of audit activities*, taking into consideration aspects such as accessibility, transparency, timeliness, and regularity of the audit reports, as well as receptiveness of the beneficiaries;
- *the independence and objectivity of auditors* (i.e., the reporting lines to which they are subject, legal guarantees and loopholes, as well as the specific regime of incompatibilities);
- *human resources management* (aspects related to staffing, salaries, career paths, and professional development, including training programs).

The study concludes with a number of policy recommendations for improving the audit system in Romanian local governments.

METHODOLOGY

The present study employs a predominantly qualitative research methodology, made up of four components, each aimed at complementing and cross-checking information of relevance to the audit system in Romanian local governments. These components are:

- a) **An analysis of the legislative framework** pertaining to internal, as well as external audit, aimed at identifying the principal characteristics of the system, strengths and weaknesses, as well as reform dynamics over the past years; in addition, relevant external or internal evaluation reports have been reviewed.¹
- b) **Focus-group sessions** with personnel involved in control and audit activities in Romanian local governments. More specifically, two focus groups were carried out: one involving financial controllers within the Chambers of Accounts (i.e., the territorial structures of the Romanian Court of Accounts),² and one involving internal auditors working in central and local public institutions. The focus group discussions sought to provide an evaluation at the grassroots level of the legislative and institutional framework of the audit function in local governments, an account of implementation problems, as well as possible suggestions for improving the existing deficiencies.

- c) **In-depth interviews** with decision-makers involved in the reform and management of the audit function at the central as well as local levels. More specifically, interviews were carried out with high-level officials in the Romanian Court of Accounts, as well as the Central Harmonization Unit for Public Internal Audit,³ a distinct structure within the Ministry of Finance, charged with coordinating the strategic development of the internal public audit system. The interviews have completed information obtained through legislative analysis and focus-group discussions with the insights of decision-makers by capturing their perceptions of the successes and failures of the audit system at the local level, in addition to further steps.
- d) **An analysis of statistical data** with relevance to the development of the audit function in Romanian local governments, such as staffing levels in the RCOA territorial structures and internal audit units in local public institutions, the number of internal audit units established at the local level, participation of internal and external auditors in professional training programs, etc.⁴ The statistical data has provided concrete benchmarks for assessing the implementation of legislation currently in place and the administrative capacity of the public audit system. The data has been compiled using the responses of public institutions to official information requests sent by the research team.

Combining different research instruments and sources, this study aims to offer the reader an impartial and representative account of the audit function in Romanian local governments, conducive to the formulation of pertinent policy recommendations. However, a few words are in order regarding the limitations of this study. It offers not an exhaustive, but rather a selective account of the most important aspects related to the legislative framework, as well as human resources development in the public audit system. Moreover, with a few exceptions, the study focuses on the present state of the system and possible directions for future development, leaving aside past institutional or policy evolutions. Owing to the amplitude of the research subject, aspects pertaining to the peculiarities of the audit function in various types of public entities, or related to different fields of activity, were not developed. Finally, our policy recommendations necessitate future in-depth analysis to establish the specific mechanisms of implementation.

1. PUBLIC INTERNAL AUDIT

1.1 The General Framework for the Organization of Public Internal Audit

The public internal audit (PIA) function was introduced in Romania in 1999, by way of the Governmental Ordinance No. 119/1999 on Internal Audit and Preventive Financial Control. Law No. 672/2002 on the Public Internal Audit fully aligned domestic conditions to the relevant requirements of the EU *aquis communautaire* (more specifically, Chapter 28) and currently regulates the field. The law defines public internal audit as a “functionally independent and objective activity, which offers guarantees and advice to managers regarding the good administration of public income and expenses. Aimed at improving the activities of the public entity; it systematically and methodically assists the public entity in fulfilling its objectives, by evaluating and improving efficiency and effectiveness of the management system, which is based on risk management, control, and administration processes.”⁵

The institutional architecture of the public internal audit system in Romania is the following:⁶

- *The Central Harmonization Unit for Public Internal Audit (CHUPIA)*, which functions as a distinct division within the Ministry of Finance, and is charged with coordinating the strategic development of the public internal audit system, including the legal and procedural framework, as well as professional development. The unit is headed by a General Director, who is a high-level civil servant, appointed by the Minister of Finance, with the endorsement of the Committee for Public Internal Audit.
- *The Committee for Public Internal Audit (CPIA)*:⁷ a consultative body, made up of specialists within public entities other than the Ministry of Finance, whose role as independent observers is to improve the development strategy for public internal audit activities, to contribute to the overall quality of the public audit, and to promote experience exchange within this field.
- *The public internal audit units* within all public entities: these are the most important component of the institutional architecture, as these decentralized bodies are the ones actually performing audit activities.

The law requires all public sector entities to set up a public internal audit unit, except for the so-called “small public institutions” (i.e., institutions which have run on a budget lower than EUR 100,000 for a period of three consecutive years). Secondary and tertiary budgetary institutions require the approval of the hierarchically superior

institution to establish a PIA unit; in case of refusal, the superior institution ensures the exercise of the internal audit function in these institutions through its own corps of internal auditors. In practice, the establishment of internal audit structures in public entities, particularly at the local level, is far from satisfactory. In 2006—four years after the entry into force of Law 672/2002 on Internal Public Audit—an official governmental report⁸ showed that 80 percent of central government institutions have set up internal audit units, while at the local level only 29 percent of the entities obliged to have such units have indeed established them. The tendency remains unchanged when analysing the actual exercise of the internal audit function for the same year—100 percent in central institutions and only 35 percent in local government entities.

Apart from this, a considerable number of PIA units have only one employee, a categorically insufficient amount of staff for fulfilling the complex attributions of such a structure and for maintaining the management of public funds within acceptable risk limits. In regard to the central government, in 2006, 25.5 percent of primary budget institutions⁹ and 45.1 percent of the public entities in their subordination had PIA units with only one employee. In the local government, 84.3 percent of the audit units created so far have only one employee.¹⁰

Official reports,¹¹ as well as focus-group discussions, and in-depth interviews with high-level officials, point to several factors determining the overall weakness and lack of administrative capacity of the public internal audit within local administration:

- lack of management awareness as to the role and importance of the internal audit function for improving the overall performance of the institution;
- the high-level employment requirements (the public auditor should be knowledgeable in economics, law, accountancy, and IT systems) make it difficult to find appropriate candidates at the local level, especially at the lowest government tiers (i.e., communes);
- the financial strains of local entities, which many times can not afford to have an internal auditor on their payroll.

On the other hand, despite legal obligation, the establishment of PIA units has not been pushed by CHUIA, principally owing to the substantial financial efforts implied. Officials have also suggested that oftentimes the activities of small public entities at the local level do not generate sizeable enough risks to require the exercise of an internal audit function—budgets cover mostly operational costs (salaries, utilities), leaving little for risk-generating operations such as investments, public acquisitions, or concession contracts.

CHUIA is now considering more cost-effective methods of ensuring the exercise of the internal audit function at the local level, namely promoting the association of seven to eight communes and one large town hall. Within such an arrangement the

larger institution would lend its audit service to smaller localities, which would then reimburse the cost of that service.

1.2 Remit of the Audit Mandate

The remit of the internal audit mandate is quite comprehensive. According to Law No. 672/2002, internal audit units must be established in all so-called “public entities,” i.e., public authorities, public institutions, independent administrative units, companies with legal personality, and where the state has ownership of over 50 percent of stocks (Article 2 (g)). Internal auditors are empowered to review the management of all “public funds,” defined by the law as funds from the central and local budgets, state insurance budget, extrabudgetary funds, state treasury funds, budgets of autonomous public institutions, funds coming from credits which are contracted or guaranteed by the state, and whose reimbursement and debt service is ensured from public funds or non-reimbursable funds (Article 2 (h)). Added to this, internal public auditors are also empowered to review the management of public patrimony, i.e., assets belonging to the public and private domain of central as well as local governments.

Throughout their missions, internal auditors have unlimited access to information considered to be relevant, and are also empowered to require documents from natural or legal persons who have interacted with the audited structure. Failure of the audited entity to provide the required documentation is punishable by fines ranging from approximately EUR 900 to EUR 1,500. Focus-group discussions, however, revealed that access to documents is sometimes hampered owing to a certain degree of hostility on the part of those audited, or because of a lack of time and personnel to process the auditors’ requests. Whenever in-depth expertise is required to carry out an audit assignment, the head of the internal audit unit may contract consultancy services outside the respective public institution.

Internal public auditors are empowered to perform three types of audits: regularity audits, performance audits, and system audits (a combination of the first two).¹² For the year 2006, official data¹³ shows that in both central and local government, the *system audit* has been the prevalent type, with a more developed regularity component. The methodological guidelines are in accordance with the International Audit Standards and provide for the use of risk assessment-based audit. Although the auditors’ yearly plans are primarily based on such assessments, they also take into account suggestions made by the head of the institution, the RCOA recommendations, and the themes set as priorities by CHUPIA. The law also provides for a number of activities and operations which should be audited at least once every three years, among which are: payment obligations, including those deriving from EU funds, the sale, concession or renting of public assets, debts and liabilities, credits, the accountancy and IT systems,

and the management and internal control systems. The head of the public entity may initiate “ad-hoc audits,” overstepping the annual audit plan in case he/she has reason to suspect an increase in the risks associated with certain activities, or the existence of important deficiencies.

1.3 Impact of Internal Public Audit

The impact of public internal audit in local governments remains low. As revealed in interviews with high-level public officials, internal auditors generally focus on stimulating the creation of operational procedures, as well as so-called “risk registries” (which list the risks associated with an institution’s activities), considered as the most important deficiencies present today in the Romanian administrative system. However, the creation of the two instruments is still lagging, particularly in local governments.

The most important avenue by which internal audit can impact the activity of a public entity is the management’s acceptance and implementation of recommendations contained within audit reports. Although the acceptance of audit recommendations is the exclusive decision of the head of the respective public body, Law No. 672/2002 provides for a specific mechanism in case of refusal, which can discourage such a decision—internal auditors signal the matter to CHUIA, providing an opinion on the consequences of such a course of action. The most significant cases are brought before the Committee for Internal Public Audit, which gives a consultative opinion on the matter.

Official data¹⁴ show that the great majority of audit recommendations have indeed been accepted by the heads of public bodies. However, according to senior officials in CHUIA, the problem is not an overt refusal, but an implicit one, by dragging the implementation of audit recommendations or simply not making any significant efforts in this direction. This state of affairs comes as a direct consequence of the lack of management awareness regarding the benefits of internal audit, but is also determined by the rather modest quality of audit recommendations. According to CHUIA officials interviewed in the present study, many recommendations pertain to superficial matters, leaving aside substantial core aspects in the functioning of an institution, or are unrealistic, not taking into account the actual time resources and administrative capacity of the respective entity, or simply come in an untimely manner, after problems have already been solved. The communication of these recommendations is considered to be a crucial matter—in this sense, CHUIA guidelines recommend the presentation of recommendations in accordance to responsible management level, and also the elaboration of a synthetic presentation of the audit report, which would be easily read and utilized by the head of a public entity.

However, as interviews and focus-group discussions have confirmed, the impact of internal audit activities is ultimately dependent on the nature of the personal relation-

ship between auditors and managers, thus making the entire matter highly context dependent.

Another aspect to be taken into consideration is the transparency of internal audit reports and the subsequent public access to these documents as a measure of ensuring management accountability. The transparency of internal audit reports is minimal—the view that the auditor acts as an aid and counsellor for heads of public entities justified the introduction in the legal text of specific confidentiality requirements. Thus, according to Article 19 of Law No. 672/2002, the internal public auditors may not divulge any data, facts, or situations uncovered during, or in connection to internal audit assignments. Moreover, the internal auditor has the obligation of protecting any documents referring to audit assignments undertaken at any public authority. In addition to this, the *Code of Ethical Conduct for Internal Auditors* lists confidentiality as among the five principles guiding the activity of internal auditors. Therefore, the internal audit reports are designed solely for the use of heads of public entities, as a tool for improving overall performance, and are not available to the public.

CHUIA officials, however, point out that despite these requirements, internal auditors are encouraged to decide, together with the heads of public institutions, if audit reports are to be made public.

Finally, an important matter to be taken into account is the channel through which auditors signal irregularities and possible infractions. Procedural norms require that, in such cases, a distinct form be filled out and the head of the public entity, as well as the internal control department be informed within a maximum of three days. When taken with the requirement of confidentiality, it becomes evident that the legal framework does not encourage internal auditors to signal misconduct outside the audited institution. According to opinions voiced during focus group sessions, internal auditors feel that dealing with malfeasance is the exclusive responsibility of the head of the institution. Interviews with CHUIA officials support this view—the task of the auditor is not to blow the whistle on irregularities, but to make all efforts to have them dealt with inside the public entity. According to the views expressed in interviews, if illegal behavior is condoned by the institution's manager, then the internal audit function becomes “improper” for that particular institution and the auditor's resignation, rather than active opposition, is seen as the appropriate solution.

1.4 Independence and Objectivity

Independence and objectivity are two of the core values presented by the *Code of Ethical Conduct for Internal Auditors*. In regard to independence, the Code defines this in relation to the audited entity as a whole, but also regarding other interest groups, internal or external to the entity. Objectivity principally pertains to the conclusions and opinions

voiced in audit reports, which have to be based exclusively on documents obtained during audit missions and analysed according to international audit standards.

The legal framework does provide for some guarantees in regard to independence and objectivity, the most important of which is that heads of internal audit units can only be appointed and dismissed with CHUPIA's accord, or, in the case of secondary- or tertiary-budget institutions, with the agreement of the hierarchical superior institution. Breaches of the *Code of Ethical Conduct for Internal Auditors* are investigated by CHUPIA, which can initiate necessary corrective measures, in agreement with the head of the respective public entity. Risk-assessment based auditing ensures objectivity in the choice of audit subjects, though the procedure is still grappling with significant deficiencies, particularly in local administration, owing to the lack of experience of public auditors, combined with a lack of proper access to know-how resources (manuals and guidelines, foreign experts, etc.).¹⁵

In practice, the independence and objectivity of internal public auditors is a relative matter, to say the least.

Law No. 672/2002 states that PIA units are directly and exclusively subordinated to the head of the public entity. Discussions with internal auditors and officials show that this subordination is perceived as the most important factor impeding the independence of internal auditors, especially for audit units with a single employee. The head of the public entity, within which the internal auditor is employed, gives an annual performance evaluation, on the basis of civil service legislation, to which most public auditors are subject. Based on this evaluation, salary increases or cuts, as well as promotions or demotions, are decided. What is particularly worrying is that civil service legislation allows for the head of a public agency to delegate the task of personnel appraisal to his/her immediate subordinates, which means that although the internal audit unit is directly and solely subordinated to top management, its performance can be reviewed by people who have been the subject of its audit missions.

When discussing the evaluation channels, it is important to note their multitude—an issue of significance for the independence of internal auditors. Apart from the evaluation executed by the head of the public entity, the Ministry of Public Finance, through CHUPIA and its territorial offices, has the task of verifying the quality of audit assignments in all primary budgetary institutions. For secondary and tertiary budgetary institutions, the supervision of audit activity is done by the hierarchically superior institution. Finally, the RCOA also performs an evaluation on the system of internal audit and the quality of audit reports. There appears to be no connection whatsoever between the evaluations performed by the head of the public agency, those performed by CHUPIA, and those of the Court of Accounts.

Apart from performance evaluations, another channel through which the independence of auditors is hampered, is the possibility of misuse by heads of public entities, of the use of so-called “ad-hoc audits,” as instruments for pressure or intimidation of

subordinates. Some participants at focus-group sessions have confirmed the existence of this practice. Because audit planning based on risk evaluation is not fully developed in local administrations, such a misuse seems more likely to occur at this level.

Senior officials at CHUIA have pointed out that auditors' independence is, in fact, a relative matter, and depends on management awareness, on the quality of the audit service provided, and on the nature of the inter-personal relationship between the management and auditors. Under these circumstances, it seems that independence is not so much a given, but a status that has to be established and permanently maintained by the internal auditor.

In regard to public integrity standards, the legal framework provides for a strict regime of incompatibilities by which public internal auditors must abide. Thus, auditors cannot perform audit assignments in those public bodies in which the head/ management council is related to them (kinship up to the fourth degree). Internal auditors may not be in any way involved in performing activities which they may potentially review, and cannot elaborate or implement internal control systems in public entities. Moreover, auditors may not undertake internal audit assignments in fields of activity in which they have worked or have been involved in any way for the previous three years.

1.5 Human resources Development

One of the most pressing problems of internal public audit in Romania is the lack of administrative capacity and inadequate human-resource development. As mentioned before, at the local government level, few PIA units have been established thus far, most of which are barely functional, having only one employee. In addition to this, the rate of occupation of internal auditor positions is low—for 2006 official data¹⁶ reflects a 68 percent occupation rate in institutions in the local government, compared to a rate of 78 percent in central government institutions, and 84 percent for public entities under their subordination or coordination. The deficit is most severe for public entities at the lowest administrative tier, namely, the communes.

In regard to career conditions for internal auditors, it is notable that, although salaries are comparatively fair, the framing of the position within the public service scheme is not adequate, being listed as a strictly executive position.¹⁷ Discussions with internal auditors have revealed that the profession is not yet fully established or perceived correctly within public entities, by management or by audited structures alike. The confusion with internal control seems to be the most common problem, explained by the relative novelty of the internal audit in Romanian public institutions, but also by the fact that many internal auditors are former controllers and inspectors. In recent years, CHUIA organized a series of seminars aimed at raising awareness among managers, as well as audited structures, of the nature, role, and value of internal audit;¹⁸ however, the general perception is still inadequate.

Parameters are established for the development of professional training, as the law prescribes a minimum of 15 working days per year to be allocated for this activity. Although not directly responsible for managing the budget for the provision of training, CHUPIA provides guidance on the matter and monitors the entire process. It is appreciated that in 2006, all internal public auditors were engaged in some form of professional training, whether domestic or developed with the assistance of foreign experts.¹⁹ The most important domestic providers are the National Institute for Administration (the state body accredited with the provision of professional training for civil servants) and the School of Public Finances and Customs (a distinct structure within the Ministry of Finance, charged with the implementation of training programs for personnel within the Ministry), together with line ministries, which elaborate their own particular training programs. As a future direction, CHUPIA is seeking to increase training regarding the fields subject to audit, rather than general training on audit procedures and techniques.

However, as focus group discussions have revealed, internal auditors feel that professional training is still insufficient. The lack of professional experience exchange is seen as an even more important problem. On top of that, the methodological guidelines produced by CHUPIA²⁰ are considered to be rather rigid and cumbersome, so that more time is taken up by producing paperwork rather than executing the actual audit activities.

On the other hand, CHUPIA officials feel that the quality of the internal audit reports is still low, and are looking for solutions to create a corps of truly professional internal auditors. Thus, they envisage the creation of a certification system, in which substantial training would be available in state universities (in the form of master's programs) and the actual certification would be performed by CHUPIA, following evaluation of candidates' files. Such a measure is conducive not only to increasing quality, but also to firmly establishing and recognizing the profession.

2. PUBLIC EXTERNAL AUDIT

2.1 The General Framework for the Organization of Public External Audit

The Court of Accounts is Romania's supreme audit institution, and performs external audit activities with regard to virtually all public-sector institutions and funds. It is important to point out from the beginning that, according to the legal provisions currently in force (Law No. 94/1992 on the Organization and Functioning of the Court of Accounts, with subsequent modifications and completions), the Court of Accounts

is defined as “the supreme institution for external ex-post financial control” (Art. 1(1)), so that its audit prerogatives are not immediately visible. It was only in 2002 that the legal framework was amended to account for these—Art. 1(9) of Law No. 77/2002 reads: “through its control, the Court of Accounts reviews the legality in the administration of material and monetary assets; also, the Court of Accounts analyzes the quality of financial administration with regard to prudence, efficiency, and effectiveness.” These evolutions clearly show that the Court of Accounts was originally designed as a financial control body that gradually took on and experimented with audit-type activities, thus evolving towards the model of a supreme audit institution.

The institutional architecture of the Court of Accounts is the following:²¹

- *The Court Plenum*, a management collegial body, made up of 18 members, appointed by the Romanian Parliament for a term of six years, following the proposals put forward by the committees for budget, finance, and banks in the Chamber of Deputies and in the Senate.
- *The Management Committee*, made up of three so-called accounts councilors, elected from among the Court Plenum members, with consistent attributions in regard to human resources policy, the appointment of management personnel, and inquiries into cases of incompatibilities.
- *The President of the Court of Accounts*, with substantial management, coordination, and representation attributions in regard to the activity of the Court of Accounts.
- *The section for ex-post financial control*, which actually performs control and audit activities, made up of seven divisions, headed by accounts councilors and staffed with financial controllers.
- *The County Chambers of Accounts* (territorial structures of the Court of Accounts), headed by a director and staffed with financial controllers.
- *The Audit Authority*, a body without legal personality, but operationally independent from the Court of Accounts, which exercises delegated financial control and audit activities of behalf of the European Union, and whose mandate covers the management of EU funds in Romania (both in the pre-accession and post-accession periods).
- *The General Secretariat*.

Until recently, the Court of Accounts also included a jurisdictional section, which functioned as a specialized court of first instance, and also as a court of appeal, dealing with financial offences, a *jurisdictional college* (a specialized court of first instance), and a corps of *financial prosecutors*. As a result of the revisions made to the Romanian Constitution in 2003, by which the jurisdictional powers of the court were transferred

to the court system, these bodies are to be eliminated.²² However, a new law, aligning the status of the court to these constitutional modifications, is not yet in force, although multiple draft laws on the subject have been initiated and rejected by the Romanian Parliament. As a result of the serious concern expressed by the European Commission's Monitoring Report of May 16, 2006, the Romanian government adopted the Emergency Ordinance No. 43/2006, which made the necessary modifications and also geared the institution almost exclusively towards audit activities. However, immediately after the ordinance was passed, the Constitutional Court dismissed it on grounds of non-constitutionality. In June 2008, a draft law formulated in consultation with foreign experts and court officials, was adopted by both chambers of the Romanian Parliament.²³ In accordance to his constitutional prerogatives, the president sent this law back to the Parliament for re-examination. It is currently being reviewed by the Commission for Finance, Budget, and Banks of the Chamber of Deputies.

Legislative insecurity is, unfortunately, a permanent hindrance in the activity of the Court of Accounts. In this regard, it is illustrative that, since its adoption, Law No. 94/1992 has been modified and "completed" no less than 10 times, and has been challenged on grounds of non-constitutionality at the Constitutional Court 28 times. Throughout this period, a revised version has been republished only once, in 2000. Legislative instability demonstrates that although its independence is not challenged overtly, the Court of Accounts represents an important stake in the internal political game, which affects its performance at all levels of government.

2.2 Remit of the Audit Mandate

Law No. 94/1992, with subsequent completions and modifications, defines (in both Article 1 and in Article 16) the audit remit of the Court of Accounts as covering "control over the formation, management, and utilization of the financial resources of the state and the public sector, as well as the management of the public and private assets of the state and of local entities."

The remit is, therefore, sufficiently inclusive, pertaining to virtually all public-sector bodies: central and local public administration, with all subordinated institutions and public service delivery structures; the National Bank of Romania; the independent administrative units; companies where public-administration bodies, independent administrative units, and public institutions hold (separately or together) more than 50 percent of social capital, and autonomous insurance bodies. Also, the court can initiate audits/controls for other categories of legal persons, such as: bodies that benefit from state subsidies or state-guaranteed credits, bodies that administer state assets, and companies that do not fulfill their financial obligations to the state.

Also, the audit remit covers a multitude of funds, transactions, and assets of central and local budgets, the state social-insurance budget, extrabudgetary funds, treasury funds,

public-debt management, state-credit guarantees, budgetary subsidies and transfers, the state public and private patrimony, and EU funds.

Through Law 77/2002, the Court of Accounts was empowered to carry out *performance*, as well as *regularity*, audits. However, insufficient administrative capacity has impeded the development of new, modern forms of audit, as a significant part of the Court's control activities are devoted to performing the annual discharge procedure for all public budget units.²⁴ Even though some progress has been achieved by increasing the Court's expertise through the piloting of financial and performance audits using international standards, it is debatable whether progress has been passed on to the local level—more precisely—to the county Chambers of Accounts. For the year 2006, the Court reported a rather balanced performance, with almost 58 percent control missions, and the remaining 42 percent audit missions, with performance audits slightly prevalent (17 out of a total of 31 assignments).

Court officials, as well as financial controllers, present at focus-group session, pointed to the need for a gradual introduction and consolidation of audit activities, together with the retention of ample control prerogatives. In the Court's view, irregularities are still rampant in public administration, particularly in local governments, thus justifying the perpetuation of control-type missions at these levels. Moreover, the existence of widespread unawareness among public-sector managers regarding the nature and benefits of audit activities, coupled with a low degree of accountability towards local communities, indicate the necessity of a more coercive approach.

2.3 Impact of Public External Audit

The Court's relationship with the Parliament, to whom it presents annual reports, is of crucial importance when analyzing the impact of its work. Unfortunately, as confirmed by Court officials and external evaluations,²⁵ the legislature's receptiveness to such reports is remarkably low. To date, there is no parliamentary body specialized in public audit matters, so that the Court is mostly in contact with the budget committees in both chambers of the Parliament, which deal with a number of other issues besides public finance audit. Apart from this, both financial controllers and Court officials feel that the findings are in no way employed in budget discussion and preparation or in other type of dissuasive measures by the Parliament.

For a long time, this lack of impact was aggravated by the backlog in presenting the Court's annual reports to the Parliament. This used to be a two-year delay, which has been steadily reduced to one year. According to the Court, this delay is largely due to the fact that the budget execution accounts are presented to it by the government within six months of the end of the fiscal year. The Court then has little time (six months) to prepare the reports for submission to Parliament.²⁶

In the absence of adequate response from the Parliament, the court system remains the only operational channel by which Court reports can impact the activity of the audited entity. Law No. 94/1992 provides that in case the Court's reports provide consistent evidence regarding the perpetration of illegal acts, the prosecutor's offices are notified immediately (Art. 31(4)). However, the weaknesses and malfunctions present the Romanian justice system affect capitalization on the Court's findings—in connection with this, focus-group discussions have pointed to a number of commonplace problems, such as defective court decisions, uneven or contradictory jurisprudence, the judge's lack of knowledge in financial matters, and the inadequate processing of notifications and supporting documents by the prosecutor's offices.

The general lack of impact is more severe with respect to audit activities, as the present legal framework is rather unclear on the mandatory character of audit recommendations. Thus, the impact of the Court's work is highly dependent on managers' openness and willingness to implement the appropriate measures. It is generally perceived by Court personnel that such conditions are met in central government institutions only, while the administrative environment in the local government is not yet prepared for audit activities.

Because clear guidelines as to the employment of audit findings are still missing, financial controllers feel that Court's evolution towards the SAI model caused them to lose authority towards those under their purview. The situation is worsened by the inadmissible delay in issuing a law to correspond to the present status of the Court, which causes financial controllers' insecurity about their status and mission.

Finally, another aspect to consider when assessing the impact of external audit, is the Court's relationship with the media. Although central coverage of the Court's activity is good, local media does not take up the subject. This state of affairs is partially explained by the fact that the Chambers of Accounts do not enjoy a distinct legal personality, and therefore cannot open their own public relations or press offices.

2.4 Independence and Objectivity

The Court of Accounts is an independent institution, responsible solely to the Romanian Parliament, to whom it presents yearly public reports. These comprise the Court's observations regarding the budget execution accounts under its purview, conclusions of the control and audit missions, the detected law infringements and corresponding reparatory measures, an evaluation of the public internal audit system, as well as any other aspects considered to be important by the Court. The regional structures of the Court (the county Chambers of Accounts) present their yearly reports to local councils (local government legislative bodies).

The Parliament's leverages of control over the Court are moderate. It appoints the members of the Court Plenum (the so-called accounts councilors) for a term of six

years, following the proposals put forward by the committees for budget, finance, and banks in the Chamber of Deputies and in the Senate. The Parliament also appoints, from among the accounts councilors, the president and vice-president of the Court. Accounts councilors are independent and irremovable from office, and also benefit from immunity (implying that all criminal procedures from custody, arrest, criminal inquiry to indictment, need special validation from the two Chambers of the Parliament, as well as a request from the General Prosecutor).

The Court of Accounts autonomously decides on its annual control and audit program, and has independence with regards to its investigations, which, as a rule, can only be stopped by the Parliament, and only when the Court abuses its powers. The Chamber of Deputies or the Senate may also ask the Court to carry out control/audit assignments outside its annual program.

However, despite these guarantees, the Court's independence has been challenged in the past by a number of legislative measures, which have subsequently curtailed its powers. For example, in 1999, the Court was denied control over privatization contracts (the choice of privatization methods, the choice of buyers, the legality of contractual causes, etc.).²⁷ Although such attacks have diminished in recent years, and are expected to cease with the long-overdue adoption of the Court's new law, RCOA management reports that the change in government still affects the institution, as newly elected political parties try to consolidate their power in local governments by pressing for the change of directors of Chambers of Accounts.

The Court's relationship with the Ministry of Finance has in the past been problematic, as the latter interfered with the Court's budget before discussion and approval in the Parliament. Since 2002, the Court has been sending its draft budget directly to the government for inclusion in the draft State Budget, and no longer—as it was the practice—to the Ministry of Finance only, thus eluding possible interference.

Court personnel at all levels are subject to strict incompatibility requirements, which should ensure their objectivity. The position accounts councilor is incompatible with any other public or private post, except for teaching positions in universities and other higher-education institutions. They are banned from taking part in political parties, and from carrying out political activities, as well as carrying out directly or indirectly, any commercial activities. Other personnel (financial controllers, civil servants, and contractual employees) are subject to the general regime of incompatibilities applicable to the civil service, which implies incompatibility with any other public or private positions, as well as the interdiction to offer consultancy to or be employed by those companies whom the civil servant used to monitor/control according to his/her competencies, for a period of three years after leaving the civil service. While high-level civil servants are incompatible with political party membership, those in the lower ranks may be enrolled in political parties, but cannot hold executive positions.

2.5 Human Resources Development

Although both the central and the territorial structures of the Court of Accounts present an occupation rate for positions of financial controllers of over 90 percent, the staff size has proven to be insufficient, especially at the local level. The Chambers of Accounts, except for Bucharest, have an average of approximately 18 positions for personnel with control and audit attributes, which, as revealed by focus-group discussions, is not sufficient for covering the entire range of public entities in a county. The recent staff increase (by approximately 31 percent) in the Audit Authority is a positive development, since the workload of this structure is expected to increase significantly with Romania's accession to the European Union in January 2007. Another positive development is represented by rather substantial salary increases for financial controllers,²⁸ which should lead to increased job satisfaction.

In regards to professional development, it is important to note that in 2003 the Court developed two audit manuals, corresponding to financial and regularity audit, as well as for and performance audit, with the assistance of foreign experts in the framework of EU-financed projects. Although the manuals are in accordance with international audit standards, their utilization by financial controllers at the local level is not yet seamless. As revealed by focus-group discussions, controllers find that the new audit methodologies require a rather lengthy planning and documentation phase, leaving too little time for the actual intervention, and thus limiting the number of significant findings. Concern was also voiced regarding the large amount of paperwork to be produced by controllers, which diverts energies from actual audit work. Finally, some participants have pointed out that training regarding the utilization of the new manuals has been insufficient.

Professional training programs for personnel active in control and audit activities are devised and managed by the central structures in the Court of Accounts.²⁹ Data from 2006³⁰ shows that *twinning* conventions account for the largest number of professional development activities (28 courses, with a total of 741 participants, and 11 pilot audits, with 63 participants). By comparison, the Court has organized, from its own budget, nine courses and experience-exchange seminars, with 218 participants. Subjects pertain to both general audit techniques (regularity/financial audit, as well as performance audit), but also to the characteristics of audited fields (e.g., banking, the utilization of European funds, environment, IT, public procurement, and state subsidies etc.).

Financial controllers at the local level find that, although interesting, participation in *twinning* seminars and pilot audits is difficult to turn to their advantage in Romania. Instead, they pointed to the need for more hands-on training regarding the utilization of audit techniques, but also regarding the specificities of activities subject to their purview. Unlike the central structure, where divisions are thematically specialized, the territorial structures of the Court are not, which puts an additional strain on controllers, who have to adapt their approach with every new audit assignment.

3. THE RELATIONSHIP BETWEEN INTERNAL AND EXTERNAL PUBLIC AUDIT

The Court of Accounts and CHUPIA signed a protocol of cooperation in the sphere of public audit in 2005, in recognition of the complementary nature of their activities. The protocol provided for methodological coordination (so that through the utilization of specific techniques and instruments, all auditors' conclusions are compatible), coordination in planning audit assignments (to avoid overlapping interventions and ensure that internal audit does precede the external one), information exchange during the unfolding of audit assignments, as well as unitary professional training (the organization of common seminars, exchange of pedagogical material etc.). Unfortunately, as noted by external evaluations,³¹ the protocol remains but a formal document still awaiting implementation.

In practice, the most notable relationship between internal and external auditors is the annual evaluation of the internal audit system performed by the Court of Accounts. As discussions with the RCOA management and financial controllers have revealed, Court personnel are reluctant to employ internal audit reports as building blocks in their control or audit assignments, since internal auditors, being subordinated to heads of institutions, are not perceived as fully independent and objective. Nonetheless, awareness exists on both sides regarding the need for closer cooperation between the public internal and external audit systems.

CONCLUSIONS AND POLICY RECOMMENDATIONS

With regard to internal public audit, we can conclude that the overhauling reforms initiated in 2002 have yet to demonstrate a consistent impact, especially at the local level, where few public internal audit units have actually been set up, and even fewer are properly staffed and functional. Although the direction of the reform is a positive one, greater efforts are required for building administrative capacity, increasing guarantees for independence and objectivity of public internal auditors, and further developing the human resources policy.

CHUPIA's intention of using associative arrangements between municipalities for the exercise of the internal audit function has potential to augment the capacity deficits present in local governments. Such a solution would especially benefit small jurisdictions, by decreasing audit-related costs and providing them with better reports (produced by a team of auditors rather than a single person). It would also determine a concentration of auditors and decrease the number of units with one employee. However, the mechanism needs to be piloted before its large-scale introduction. At the same time, the measures for raising management awareness on the role and importance of the PIA need to be intensified; otherwise, willingness to enter associative arrangements will be minimal.

Added to this, a reconsideration of the EUR 100,000 budget threshold for the establishment of PIA units is in order. Policy-makers should appraise the risk levels attached to operations funded by such a budget and pay due consideration to institutions' capacity of bearing the costs of a full-blown team of auditors on their payroll. If considered appropriate, raising the threshold can decrease the number of PIA units with one employee. As an additional measure in this direction, a quota could be established, ensuring that all units have the critical mass of staff to function appropriately.

A number of measures are also in order for consolidating the independence and objectivity of internal auditors. As a measure of insulation from managerial abuse, the performance evaluations given by CHUPIA and the heads of public entities could be correlated, so that ensuing measures such as salary cuts or increases, are dependent on both. Such a mechanism could be easily accepted, as appointment and dismissal already require CHUPIA's accord.

Added to this, legislation should be improved by defining clearly and exclusively the circumstances allowing managers to require "ad-hoc" audits so as to prevent misuse of these as instruments of control.

Another problematic matter is the auditors' ability to signal irregularities or infractions outside the public entity in which they work, once all internal routes have been utilized, with no result. PIA legislation is quite opaque on the matter, but internal auditors are—like all public sector employees—subject to whistleblower protection, regulated by Law No. 571/2004 on the Protection of Personnel from Public Authorities, Public Institutions, and from other Establishments who Signal Legal Infractions, which encourages and protects those who, in good faith, inform on any action which presupposes a violation of the law, of professional ethical standards, or of the principles of good administration, efficiency, efficacy, economy, and transparency. Awareness of such specific rights and protection should be increased among internal auditors. Also, PIA legislation should be modified so as to explicitly accommodate and explain the confidentiality principle in relation to auditors' right to act as whistleblowers.

The human resources policy could also be improved in several ways. The profession of internal auditor is in need of better establishment and recognition. Efforts to raise awareness regarding public internal audit should continue, targeting both managers and personnel subject to the auditors' purview. Moreover, the framing of the position within the scheme of public post should be revised, as public internal auditors do not have purely executive attributions, but are functionally independent in relation to their employer.

The supply of professional training programs should be increased. In this respect, CHUPIA could assume a proactive role in relation to training providers, by initiating collaboration protocols and coordinating curricula.

Finally, the certification system envisaged by CHUPIA, should increase the status of the profession, as well as overall excellence. However, officials could consider multiple

alternatives for providing education in view of certification. Apart from establishing master's programs in state universities, a more intensive utilization of the internal educational infrastructure could be considered—as mentioned before, the Ministry of Finance established, in 2000, the School for Public Finance and Customs, which deals specifically with the provision of training for MoF personnel.

In the long run, policymakers may consider transferring CHUPIA's attributions to an autonomous PIA agency, which would manage professional development (including a future certification system) and assign internal auditors to public entities, thus terminating the present subordination to management.

Being the object of intensive reform over the past few years, the Romanian Court of Accounts is currently a strong institution, whose activity conforms to international standards in the field.

The most pressing problem confronting the Court of Accounts today is the lack of a legal framework in line with the 2003 constitutional changes. Policymakers should make it a high priority to speed the adoption of such a law, which would explicitly state the Court's audit prerogatives, while preserving the current mix of control and audit activities. Furthermore, the new law should clarify the methods of utilizing audit recommendations. At the same time, the Court must continue efforts to develop modern forms of audit on a larger scale.

Another issue of importance is the relatively limited impact of the Court of Accounts activities. In connection with this, their relationship with the Parliament should be improved, possibly by establishing a parliamentary body specialized in public audit matters, which would deal directly with the Court. In addition, the Court could consider increasing its openness to the public, by simplifying the language of the audit reports and improving their public availability, actively seeking partnerships with relevant civil society organizations, and improving its website.

Finally, in regard to the human resources policy, a priority should be an overall staff increase, particularly within the Chambers of Accounts. Moreover, the Court should seek to further develop its own professional-training capacity since, at the moment, training is provided predominantly within the framework of *twinning* conventions.

One final aspect that should be a point on the agenda for further reform is the improvement of cooperation between public internal and external audit bodies. The Protocol signed in 2005 by the RCOA and CHUPIA should be implemented, or if need arises, renegotiated. Internal and external audit structures should focus on experience exchanges and a continual transfer of best practices.

APPENDIX 1

Statistical Profile of the Public Audit System in Romania*

Table A1.1

The Public Internal Audit in Central and Local Public Administration

The PIA function	Administrative tier		
	Central Public Administration		Local Public Administration
	Primary budget institutions	Secondary and tertiary budget institutions	Public entities with an obligation to establish PIA units
Total number of public entities	51	1,212	2,625
Number of public entities with PIA units	51	962	763
Degree of establishment of PIA units	100%	79.3%	29%
Number of public entities with PIA units with one employee	13	547	643
Percentage of PIA units with one employee (from total PIA units)	25.5%	56.9%	84.3%
Exercise of the PIA function in 2006	100%		35%

* The data presented in this appendix pertains to 2006, and was collected from the *Annual report on Public Internal Audit* for 2006, elaborated by the Central Harmonization Unit for Public Internal Audit within the Ministry of Finance, as well as from answers to surveys delivered by officials within the Ministry of Finance and the Romanian Court of Accounts.

Table A1.2
Occupation of Posts in Public Internal Audit Units and
the Romanian Court of Accounts

Number of posts	Administrative tier				
	Public Internal Audit Units		The Romanian Court of Accounts		
	Central Public Administration	Local Public Administration	The central structure	The Audit Authority	The territorial structures (Chambers of Accounts)
Total number of posts	2,070	1,273	191	182 + 57 new posts to be filled in 2007	786
Occupied positions	1,708	864	176	179	753
Degree of occupation	82.5%	67.9%	92.1%		95.8%

APPENDIX 2

Attributes and Competencies of the Primary Institutional Actors in the Public Internal Audit System

The Committee for Public Internal Audit (CPIA) gives its consultative opinion and/or binding notice to CHUPIA with regard to:

- the development strategy for the internal public audit system elaborated by CHUPIA;
- legal acts drafted by CHUPIA;
- plans for inter-sector audit assignments executed by CHUPIA;
- audits reports for inter-sector assignments of national interest, executed by CHUPIA;
- cooperation agreements between the internal and external audit structures;
- the appointment and dismissal of the General Director of CHUPIA;
- the annual report on the internal audit activity, elaborated by CHUPIA;
- and in case of diverging opinions between heads of public entities and internal auditors, CAPI analyses the importance of recommendations formulated by the latter and gives an opinion on the consequences of not implementing them.

The Central Unit for Harmonization of Public Internal Audit (CHUPIA)

- directly subordinated to the Minister of Finance;
- elaborates and applies a unitary strategy in the field of internal public audit and monitors this activity at the national level;
- develops the legal framework in the field of internal public audit;
- develops and implements uniform internal public audit procedures and methodologies, including manuals, in accordance with international standards in the field;
- develops the *Code for Ethical Conduct of Internal Auditors*;
- develops the system for reporting results of public internal audit activity;
- elaborates the annual report on internal public audit activity;
- executes inter-sector internal public audit assignments deemed to be of “national interest”;

- verifies the adherence of internal public audit units to specific norms and instructions in primary budget institutions;
- verifies the adherence to the *Code for Ethical Conduct of Internal Auditors*, and is empowered to initiate necessary corrective missions, working together with the head of the respective public entity, in primary budget institutions;
- coordinates the recruitment and professional training system in the field of internal public audit;
- gives notice on appointment and dismissal of heads of public internal audit units, for primary budget institutions;
- cooperates with the Court of Accounts and other public institutions in Romania;
- cooperates with foreign financial-control institutions, including the European Commission.

Internal public units in primary budget institutions

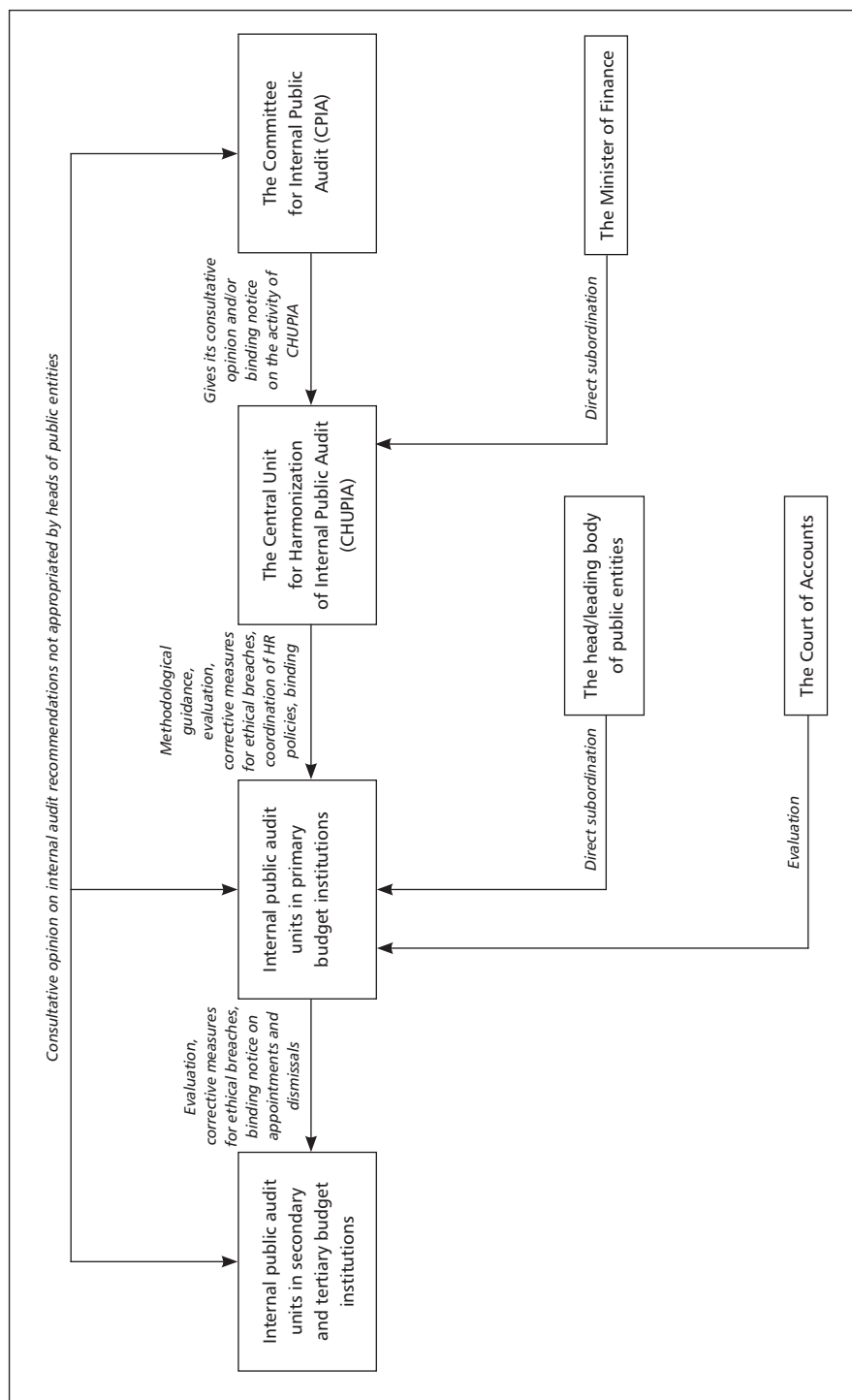
- are directly subordinated to the head of the respective public entity;
- with CHUPIA's notice, they elaborate methodological norms specific to the public entity in which they carry out their activity;
- inform CHUPIA on recommendations not appropriated by the head of the public entity in which they work, outlining the consequences for such a course of action;
- report annually to CHUPIA on their audit activity;
- follow up on the implementation of recommendations contained within audit reports and report back to the head of the public entity, as well as CHUPIA;
- in case they identify irregularities and possible prejudices, they immediately inform the head of the respective public entity and the internal control structures;
- decide on the creation of internal public audit units in secondary and tertiary budget institutions under their subordination/coordination;
- give notice on specific audit methodological norms in secondary and tertiary budgetary institutions under their subordination/ coordination;
- verify adherence to the *Code for Ethical Conduct of Internal Auditors* in secondary and tertiary budget institutions under their subordination/coordination, and can initiate necessary corrective measures together with the head of the respective entity.

The head/leading body of a public entity

- appoints and dismisses the head of internal public audit unit, with the binding notice of CHUPIA;
- performs the annual performance evaluation for all employees, including internal auditors;
- approves the annual audit plan elaborated by the internal audit unit;
- can request “ad-hoc” audits;
- analyses and gives notice on audit reports, and oversees the appropriation of recommendations.

The Court of Accounts

- is an autonomous institution under the control of Parliament;
- evaluates the internal public audit activities.



APPENDIX 3

Attributes and Competencies of the Primary Institutional Components of the Romanian Court of Accounts

The Court Plenum

- approves the Court's internal regulations, ethical code, staffing levels, and the annual programs of financial control and audit;
- endorses, at the request of the Senate or the Chamber of Deputies, public budget drafts or draft laws in the field of public finance and accountancy, which would create a diminution of public incomes or an increase of expenses;
- endorses the establishment of bodies subordinated to the government or line ministries, at the request of the Parliament;
- decides on the modification of the internal structure of the Court of Accounts, without affecting its competencies and budget;
- issues mandatory instructions to the Court's financial control bodies;
- debates on the Court's budget;
- requests and examines reports on the activity of the section for ex-post financial control and of the Chambers of Accounts;
- elects the three accounts councilors who will make up the management committee;
- examines and approves the custody, arrest, criminal inquiry, and indictment of financial controllers.

The Management Committee

- organizes the control missions requested by the Parliament, as well as missions not incorporated into the Court's annual program of financial control and audit;
- initiates inquiries for Plenum members or financial controllers facing incompatibilities;
- approves the list of vacant positions and organizes selection procedures;
- appoints directors of control directions, as well as the directors of the Chambers of Accounts and the General Secretary of the Court of Accounts;
- approves the Court's contracts for all goods and services.

The President of the Court of Accounts

- represents the Court in relation to public institutions and domestic or international bodies active in the field of audit and financial control;
- coordinates the activity of the Court of Accounts;
- convenes and presides over meetings of the Plenum and of the management committee;
- transmits the Court's annual report to the Parliament;
- appoints and dismisses Court staff (except for those appointed by the Plenum and the management committee), and applies disciplinary sanctions for breaches of the professional ethical code.

The Section for *ex-post* financial control

- is made up of seven sector divisions, headed by an accounts councilor;
- performs the annual discharge procedure, financial controls, and audits.

The Chambers of Accounts

- the territorial structures of the Court of Accounts (42 in total, one for each county and one for Bucharest), headed by a director, without a distinct legal personality;
- perform the annual discharge procedure, financial controls, and audits.

The Audit Authority

- a body without a distinct legal personality, but operationally independent from the Court of Accounts, headed by a president, with distinct territorial structures (regional audit offices);
- performs the delegated financial control and audit of EU funds in Romania.

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NOTES

- ¹ SIGMA annual assessment reports, produced upon request of the European Commission, as a contribution to the *Commission's Progress Reports* and to its programming of technical assistance (SIGMA. 2006. *Romania Public Internal Financial Control Assessment*. Paris: OECD and SIGMA. 2005. *Romanian External Audit Assessment*. Paris: OECD, available online at http://www.sigmaweb.org/document/29/0,2340,en_33638100_34612958_36494941_1_1_1_1,00.html), as well as reports of domestic institutions (The Ministry of Finance, 2005 and 2006. *Report on the Internal Public Audit Activity*, Bucharest, available online at: <http://www.mfinante.ro/audit/index.jsp> and the Romanian Court of Accounts, 2006, *Public Report for the Year 2005*, Bucharest).
- ² In Romanian, *Curtea de Conturi a Romaniei*. Henceforth referred to as RCOA.
- ³ In Romanian, *Unitatea Centrala de Armonizare pentru Auditul Public Intern*. Henceforth referred to as CHUPIA.
- ⁴ For a complete account of statistical data, see Appendix 1.
- ⁵ Article 2 (a) of Law No. 672/2002. Focus-group discussions with public internal auditors have shown that, in practice, the above definition has proven to be rather unclear and unworkable; as a common conception, auditors take their role to consist of drafting recommendations for improving the activity of a public entity.
- ⁶ For a detailed account on the institutional framework of the public internal audit system and the relations between the main actors, see Appendix 2.
- ⁷ In Romanian, *Comitetul pentru Audit Public Intern*. Henceforth referred to as CPIA.
- ⁸ Ministry of Public Finance (2006) the *Report on the Internal Public Audit Activity*, Bucharest. Available online at: http://www.mfinante.ro/audit/RAP_GUVERN2006.pdf.
- ⁹ The Romanian administrative system establishes their hierarchical subordination of public institutions according to their budget-spending prerogatives. Primary budget institutions receive funds directly from the central State Budget and further allocate resources to secondary budget institutions which are in turn responsible for allocation to tertiary budget institutions.
- ¹⁰ Ministry of Public Finance (2006) *Report on the Internal Public Audit Activity*, Bucharest.
- ¹¹ Ministry of Public Finance (2005 and 2006) *Report on the Internal Public Audit Activity*, Bucharest, SIGMA, 2006. *Romania Public Internal Financial Control Assessment*, Paris, OECD.
- ¹² The definitions of these types of audit are contained within Article 12 of Law. No. 672/2002. *System audit* represents “an in-depth evaluation of the systems of management and internal control, with the purpose of establishing whether these function in an economic, efficient, and effective manner, to identify deficiencies and to formulate recommendations for correction.” *Performance audit* examines whether “criteria established for the implementation of objectives and tasks of the public entity are appropriate for evaluating results and appraises whether results are in accordance with the objectives.” Finally, *regularity audits* are defined

as “the examination of actions with a view to financial effects on public funds and public patrimony, and to the respect of the set of principles, as well as procedural and methodological rules applicable to them.”

- ¹³ Ministry of Public Finance (2006) *Report on the Internal Ppublic Audit Activity*, Bucharest.
- ¹⁴ The Ministry of Public Finance (2006) *Report on the Internal Public Audit Activity*, Bucharest.
- ¹⁵ Ministry of Public Finance (2006) *Report on the Internal Public Audit Activity*, Bucharest.
- ¹⁶ Ministry of Public Finance (2006) *Report on the Internal Public Audit Activity*, Bucharest.
- ¹⁷ For more on this, see Law No. 188/1999 on the Statute of Civil Servants, with subsequent modifications and completions.
- ¹⁸ In 2006, seminars were organized with the assistance of experts form the European Commission and involved around 300 managers.
- ¹⁹ Ministry of Public Finance (2006) *Report on the Internal Public Audit Activity*, Bucharest.
- ²⁰ In 2003, the Ministry of Finance issued Order No. 38/2003 on the General Norms Regarding the Exercise of Public Internal Audit, and subsequently elaborated a number of thematic manuals focused on various support functions in public institutions (judicial activity, IT, accountancy, public procurement, and human resources). Additionally, the Ministry issued in 2005, Order No. 1702/2005 on the Organization and Exercise of the Counseling Activity.
- ²¹ For a more detailed description see Appendix 3.
- ²² The specialized RCOA courts were transferred to the general court system in 2003, by way of Governmental Emergency Ordinance No. 117/2003, while the financial prosecutors were transferred to the Public Ministry two years later (Governmental Emergency Ordinance No. 53/2005).
- ²³ For more details, see http://www.cdep.ro/pls/proiecte/upl_pck.proiect?cam=2&idp=8248.
- ²⁴ SIGMA (2005) *Romania External Audit Assessment*, Paris: OECD.
- ²⁵ Idem.
- ²⁶ Idem.
- ²⁷ Law No. 99/1999 on Measures for Accelerating Economic Reforms.
- ²⁸ Salaries were increased in 2006 by way of Law No. 233/2006, and again in 2007, by way of Governmental Ordinance No. 27/2007.
- ²⁹ The Court has a specialized *direction for methodology, professional training, evaluation of professional activity of directions for external ex-post financial control, reporting, IT and European integration* which coordinates the implementation of audit methodologies, as well as professional training programs.
- ³⁰ According to data offered by officials in the Romanian Court of Accounts.
- ³¹ SIGMA (2005) *Romania External Audit Assessment*, Paris, OECD.

Audit Function Survey, Russia

Vera Beskrovnaya and Tatiana Vinogradova

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METHODOLOGY

For undertaking a survey of existing audit practices in Russian local governments, two primary methods were utilized: interviews with experts in the field, as well as research of the normative basis for exercising financial scrutiny at the federal, regional, and local levels of government. For research examples, three municipal districts of different types were chosen: a city settlement (the town Velikie Luki of Pskov *Oblast*), a village settlement (Velikoluksky *Rayon* of Pskov *Oblast*), and a municipal district within a city of federal definition (constituency No. 78 of the Central District within St. Petersburg). Three interviews were conducted: with the head of the financial department of the executive administration of the municipal district, the head of Control Inspection Department, and the head of the Budget Finance Committee of the representative body of local government, which is entrusted with responsibilities of control.

Also analyzed as data for this report were materials published on the website of the Audit Chamber of the Russian Federation, Audit Chambers of the subjects of the Russian Federation and control-inspection bodies of the local government.

RESEARCH HYPOTHESIS

- 1) The present normative basis for the financial audit of local government in Russia does not assure its efficient functioning, legitimacy, integrity, or interrelationship of its elements.
- 2) The current system of internal and external control of local management practice in the Russian Federation impedes the financial audit function in local government.

1. LEGISLATION

1.1 Governmental Scrutiny in the Sphere of Financial Management of Local Government

Currently, conceptual changes have been accepted in the Budget Code of the Russian Federation (RF). They are aimed at increasing the efficiency of the budget system of the RF, including local budgeting. The possibility of the establishment of internal financial audit departments for executive government bodies is now provided for within the new legal framework. These departments are to implement the development and control for

the internal standards and procedures of drawing up and executing the budget, preparation budget reports, and accounting.

Federal legislation makes provision for the state government bodies' control over the execution of some state credentials by local governments, and over this function's material resources and financial funds. The control body of the local government (the Control Auditing Chamber or "*controlno-schetnaya palata*," and the Inspection Commission or "*revisionnaya komissiya*," etc.) were formed for the control over the execution of local government budgets, maintenance of the established order of preparation, assessment of local budget drafts, reports on its execution, and to achieve the goals of control for the maintenance of the established order of local government property management and disposal. The results of the inspection, which are performed by the control body of the municipality, are required to be publicized.

- *How does the legislative framework of local government provide for adequate scrutiny of local governments' financial management?*

According to the law currently in force, the bodies of the government financial oversight are the following: the Audit Chamber of the Russian Federation, the control and financial arms of the executive government bodies, the control and financial arms of the legislative government bodies of the citizens of the Russian Federation.¹ The legislative control bodies scrutinize and confirm the budgets, report on their execution, and perform the follow-up control for the execution of the budget; as well as form and define the legal status of the bodies, which perform control over the execution of the budgets of corresponding levels of the budget system of the Russian Federation.²

Legislative bodies exert the following forms of financial control:

- Preliminary control—in the course of the discussion and approval of the budget-law drafts and other law drafts on budget finance issues;
- Current control—in the course of reviewing the separate issues of the budget execution during the sessions of the committees, commissions, working groups of the legislative bodies, in the course of parliamentary hearings, and in connection with deputies' requests;
- Follow-up control—in the course of reviewing and approval of the reports on budget execution.

Scrutiny of the legislative bodies provides their right to:

- Receive from the executive bodies of government the necessary additional accompanying materials when the budget is approved;

- Receive operational information on budget execution;
- Approve the report on the budget execution;
- Establish their own control bodies (the Auditing Chamber of the Russian Federation, control chambers, and other bodies of the subjects of the Russian Federation for conducting the external audit of the budget);
- Evaluation of the activity of the bodies executing the budgets.

Executive government bodies are responsible for providing all information necessary for performing parliamentary control over the legislative government bodies within the bounds of their competence on budget issues.³

Financial scrutiny of executive government bodies is accomplished by the Federal Service of Finance Budget Oversight, the Federal Treasury, financial bodies of the subjects of the Russian Federation, senior superintendents, and superintendents of budget funds. The forms and order of performing the financial inspection are regulated the federal normative laws and acts of the subjects of the Russian Federation.⁴

The Federal Treasury is responsible for the scrutiny of the following:⁵

- Not exceeding the limits of the budget obligations of the funds of the federal budget;
- Not exceeding the cash disbursements, as incurred by the recipients of the funds of the federal budget;
- Ensuring the content of the conducted operation corresponds to the proper code of budget classification, as indicated in the check by the recipient of the funds of the Federal Budget;
- Availability of proper documentation from funds' recipients, confirming the origins of the monetary obligations.

The Federal Service of the Finance Budget Oversight executes the financial scrutiny of the Federal Budget funds' and Federal extrabudgetary funds' use.⁶

Federal legislation towards financial management of the local government is perfunctory, defining but general conditions of the finances of the local governments' functioning. Additionally, federal bodies do have neither unified rules and standards of audit function, nor unified report norms, nor methods and methodology for monitoring. The system of municipal financial-scrutiny, in terms of legislation, is undeveloped. Any assessment of the present state, and results of municipal financial scrutiny meets certain difficulties concerning a lack of confirmed standards and clas-

sification of legal infringements, unified interpretation of the types of infringements regarding illegitimate, purposeless, or inefficient use of budget funds.

- *Does the law empower and require State Audit bodies to audit the financial affairs of local governments?*

The Audit Chamber of the Russian Federation, the Federal Service of Finance Budget Oversight, control bodies established by the legislative body of the subject of the RF, the financial body of the subject of the RF, and other bodies entitled by the executive body of the subjects of the RF are allowed to scrutinize local budgets.⁷ In Russia, in fact, a centralized system of financial management has been formed. Municipalities are the lowest level of management, accountable to the subjects of the RF and the federal center. (At the same time, the legislation declares local governments' independence.⁸) Owing to the existing practice of the unified system of financial management in Russia, the managers of the financial organs of the executive bodies of municipalities are accountable to the managers of the financial bodies of the subjects of the RF. Therefore, regional financial scrutiny is extended to the entire activity of the municipal districts, a foreseen result of the legislation.

- *Is such scrutiny limited to State Budget subventions? Does it cover the use of other revenues, such as intergovernmental transfers, local "own" revenues, etc.?*

The Audit Chamber of the Russian Federation, the Federal Service of Finance Budget Oversight, control and financial bodies of the subjects of the RF, and other bodies entitled by the executive body of the subjects of the RF are allowed to scrutinize the local budgets, and recipients of the inter-budgetary transfers from the federal budget as well as from the budget of the subjects of the RF. In fact, the scrutiny also covers the major part of the budget of the municipality, as the local budgets consist of just 10 to 30 percent of their own funds. The other share is for subventions, subsidies, and transfers from the upper-level budgets.

- *Do state auditors report to Parliament, local councils, or to both?*

Current legislation does not provide for any procedures for presenting reports on the results of the implementation of governmental scrutiny. As practice illustrates, the reports remain within the government structures that performed them. An exception is that of the reports on the execution of the budget, which are presented for the consideration of the legislative government bodies within the framework of the approval of the budget-execution report procedure.

- *Are their reports accessible to local councils, the local media, and civil society?*

The reports of the government control bodies are not available to the municipal subjects of financial management. At the same time, prescriptions and recommendations on results of the inspection (audit) are brought to the notice of the head of the local government and the head of the financial body of the executive government of the municipality.

- *Does state audit extend to the affairs of local budget institutions?*

The appropriate representative body is able to entrust the control body of the subjects of the RF with scrutiny of the financial state of the recipient of any governmental or municipal guarantee.⁹ Control and financial bodies of the subjects of the RF perform the financial scrutiny for the operations with budget funds of the main superintendents, superintendents, and recipients of budget funds of the corresponding budgets, as well as for the maintenance of the conditions of allocation, receiving, purpose-use, and repayment of budget funds by the recipients of the budget credits, budget investments, and governmental guarantees.¹⁰

The main superintendents and superintendents perform the financial scrutiny of the use of the budget funds by the recipients in part of the provision of the purpose-use and timely repayment of budget funds, as well as corresponding reporting and paying in for the use of budget funds. The main superintendents carry out the scrutiny for the government, state, and municipal companies, budget establishments, and autonomous establishments that are within their jurisdiction.¹¹

In fact, state government scrutiny concerns only the issues of the purpose-use of subsidies and subventions allocated to the budget establishments from the upper-level budgets.

- *Does it cover issues of viability and efficiency as well as legality?*

Financial scrutiny concerns issues of efficiency of budget-fund use and, to a lesser degree, the quality of financial management. Its results are rarely used in budget formulation and other decision-making processes.

1.2 Municipal External Scrutiny

Regional normative standards in force merely repeat the statements of the federal legislation, and deliver all responsibility for the organization of the financial audit to the local governments.

Local normative standards on financial audit are practically absent. Control bodies are formed on the basis of the federal law; regulations on the already-mentioned bodies functioning are now in the development stage.

- *Are local governments required to appoint external auditors to cover the financial affairs not scrutinized by State Audit?*

Local governments provide their corresponding local government bodies with the right to establish their own entities with the view to conduct an external budget audit. Municipal financial scrutiny bodies are the control bodies of the representative bodies of local government.¹² Representative bodies of local government examine and confirm budgets and reports on their execution, perform the follow-up control for budget execution, provide the expertise for budget drafts and the other normative documents of the local government bodies; and form and define the legal status of the bodies that examine the execution of the local budgets.¹³

Through consideration of the report on budget execution by the representative body of the local government, the external scrutiny of the report is performed. External scrutiny of the report on budget execution is carried out by corresponding scrutiny bodies of the representative bodies. The representative body makes their decision on the report on budget execution only after the receiving the results of the scrutiny of the above-mentioned report, which is performed by the corresponding entity.

A control-accounting body within the representative government body accomplishes the control inspection, as well the expert-analysis, according to the working schedule.

The priority directions in the activity of the already-mentioned body are the scrutiny of the budget execution, use of the budget funds, municipal property, and rendering commercial services by the municipal organizations in socially meaningful fields.

In the course of preparing their conclusions and data, the control body not only verifies the facts on the results of performed control-inspection activities, but presents an analysis of the reasons for infringements, and notifies the subject about the consequences of the accounting infringements so that future preventative measures can be taken.

The representative body is entitled to apply to the procurator bodies of the RF for scrutiny of the circumstances of any non-correspondence to the budget's execution, regarding a previously-made decision on the budget, in the instance that the body exceeded its rights in executing the budget, and to call it to account for infringements. Any temporary financial administration, introduced into the municipal constituency, is entitled to contract out the audit of the local government budget.¹⁴

In accordance with current federal legislation and the Law on Audit Activity,¹⁵ audit activity is performed for the assessment of the reliability of financial (accounting) reporting of the subjects of the audit, and its accounting compliance to the legislation of the RF. The budget activity of the local government bodies is out of the purview of the mentioned law.

In the structure of the local government bodies, the control body of the municipal constituency (the control-accounting chamber, the inspection commission, and others) is included.¹⁶ It was formed to heighten scrutiny of the execution of the local budget, to closer observe the stated order of the budget's preparation, to report on its execution, as well as assure the observance of the stated order of the managing and disposing of that which is regarded as municipal property.

The control body of the municipal constituency is formed at the municipal elections or by the representative body, in accordance with the municipal constituency's charter. Local government bodies and appointed officials of the local government are responsible for presenting to the control body of the municipal constituency, upon its request, the necessary information and documents on issues concerning its competence. The employees of the control body have occasion to challenge the flaws in the normative-legal base, for instance, if there is no reliable and efficient mechanism for the repayment of municipal funds; or if those funds were used for a non-purpose function, without oversight from the corresponding appointed officials or have led to the loss of financial resources.

- *What qualifications are required of external auditors?*

The legislation does not define the requirements for the external auditors. When forming the scrutiny bodies, in practice, non-formalized criteria are usually applied: high-level of education in economic science and professional experience in working with budgets.

- *To what degree are qualified auditors affordable, particularly to small local governments?*

The staff of auditors (inspectors) in the local executive government bodies is full (no current vacancies). In the representative bodies, there are still unfilled staff positions, owing to the small salary.

As we can conclude through relevant interviews, the qualifications of the auditors (inspectors) is in direct proportion to the size of the municipal constituency. In city settlements, auditors (inspectors) are more qualified and experienced than in village constituencies. In small local governments, auditors (inspectors) may have no higher education in economics, just technical secondary school.

Thus, the affordability of auditors (inspectors), particularly by small governments, is low.

- *Do external auditors cover local budget institutions?*

The representative body may entrust the control body of the subjects of the RF with the responsibility to carry out the inspection of the financial state of the recipient of state or municipal guarantee.¹⁷ External auditors reveal financial infringements of the following order: unpurposeful use of budget funds, and inefficient use of municipal property. Following the audit, the appropriate funds are recommenced in the local budget.

The control body is not fully able to cover with its audit activities all companies or establishments receiving budget funds or using municipal property. It is evident that the level of financial discipline and the level of professional education of the accountants is especially low in municipal establishments; as internal scrutiny is weak or absent. The weakest unit within municipal companies is the juridical services unit. Thus, contract relations suffer with defects within the financial-economic relations of the companies.

- *Do external auditors cover aspects other than legality?*

Normative acts do not envisage the scrutiny of efficiency. In practice, issues of efficiency in the audit are not covered, because of a lack of auditors, as well as a lack of criteria and methodology of evaluation of efficiency.

- *Who has access to their reports?*

In the analyzed normative acts of the municipal constituencies, the promulgation of acts of external scrutiny is not envisaged. Nor is it accomplished in practice. The results of the audit are sent by the control bodies of the representative government to the deputies, and to the head of the municipal constituency. Aside from this, the statements and prescriptions are sent to the heads of the different levels; requests are made to different instances, authorities, and establishments.

1.3 Municipal Internal Scrutiny

- *Are local governments required to employ internal auditors?*

The municipal financial control bodies, established by the local government bodies, perform the preliminary, current, and follow-up control on budget execution. For

the goals of servicing the local budget and managing local budget funds, municipal constituencies have established municipal treasuries and (or) other financial bodies (appointments) in accordance with the charter of the municipal constituency and the legislation of the Russian Federation.

Local government bodies perform the formation of the budget draft, submit it with necessary additional documents and materials for the approval of the representative local government body; accomplish the execution of the budget, including budget revenue collection, managing municipal debt, departmental scrutiny of the execution of the budget; and present the report on budget execution for the approval of the representative bodies of the local government.¹⁸

Internal control is realized by the specially established entities within the structure of the financial body of the executive branch of the local government control-inspectional department or directorate. Said body performs the audit and makes inspections according to its own plan. It is accountable to the regional financial body of the upper-level department, and performs audit on the request of the bodies of domestic affairs.

- *To whom are the internal auditors responsible: councils or executives?*

The legislation does not regulate to whom the internal auditors are responsible. In fact, they are responsible to the head of the financial body of the municipal constituency and corresponding directorate in the financial body of the regional level. Formally, the results of the audit are brought to the notice of the deputies of the representative government body, along with the report on budget execution.

- *Are the internal auditors' reports accessible to councilors, the media, and civil society?*

The results of the audit, performed by the control body of the municipal constituency, are to be promulgated, and should be accessible to both councilors and media. (This concerns “departmental” control, Article 154 of the Budget Code of the Russian Federation, and only departmental, which is within the financial body.) In practice, this is not fully accomplished. In reality, in the explanatory note to the draft of the law on the approval of the report on budget-execution, the list and the results of audit are attached. This is not publicized through the mass media. (The external control—performed by the representative body—is not publicized by legislation either.) In practice, results of the audit are read out at the sessions of the councils for councilors, but this also happens rarely, and this is at the initiative of the control body. Other actors, i.e., civil society, do not receive any information.

- *Do internal auditors inspect budget institutions?*

Control financial bodies of the municipal constituencies perform the financial scrutiny for the operations with budget funds of the main superintendents, superintendents, and recipients of budget funds. They do the same for maintenance of the recipients of budget credits, budget investments. The municipality guarantees the conditions of allocation, drafting, purposeful use, and repayment of budget funds. The main superintendents and superintendents of budget funds perform the financial audit for the use of the budget funds regarding its purpose use and timely repayment. They also render the reporting and appropriate accordance of the payment for the use of budget funds. The main superintendents of budget funds carry out the audit of the establishments which are within their jurisdiction as well as autonomous establishments. Generally, the audits are directed towards revealing the purposeful use of budget funds within the budget establishments, rendering payable services, and the use of municipal property. Infringements revealed include illegal over-staffing, expenditures receipts, derivations in employees' salary accounting, and unapproved prices for rendering payable services.

- *Do internal auditors cover issues of efficiency as well as legality?*

The concept of administrative reform in the RF anticipates the development and introduction of the system of internal audit, allowing for the evaluation of efficiency of activity of structural departments and officials. It also allows for scrutiny of the efficiency of budget expenditures. However, currently, the audit is more directed towards ascertaining the legality of activity.

1.4 Municipal Companies

- *Who audits municipal companies?*

The proprietor of the property of the unitary company in relation to this company makes decisions on carrying the audits, approves the auditor, and defines the amount of the remuneration for the service.¹⁹ Accounting reporting of the unitary company is subject to a compulsory annual independent audit. Scrutiny of the activity of the unitary company is accomplished by the body which realizes the credentials of the proprietor, or by other plenipotentiary bodies.²⁰

In relation to the municipal unitary companies, which are established as corporations, should their volume of receipts from production realization (fulfilled works or rendered services) for one year exceed 500,000 times that fixed in the Russian Federation legislation for the minimum wage, or the sum of activities of the balance

exceed, for the end of the reporting year, 200,000 times that fixed in the Russian Federation minimal amount of labor remuneration, then a compulsory audit is performed. For municipal unitary companies, the law of the subjects of the RF may decrease the financial indicators.²¹ Compulsory audit is the annual compulsory scrutiny of the carrying out the book-keeping and financial (accounting) reporting of the organization.

In fact, these municipal companies are scrutinized as to which tariffs on services are approved by the representative government body (such as heating and water companies). With those, not only is financial scrutiny demanded, but also a technical-economical audit. The remaining companies are scrutinized only in the case of transferring to them due subventions from the local budget.

- *To whom do municipal companies report?*

Municipal companies report to their proprietor. In reality, the audit of these companies is made only in certain cases, like when the companies get their financing in the form of subsidies or subventions from the local budget.

- *On what do municipal companies report?*

The unitary company, by the end of the reporting period, present to the plenipotentiary bodies of the government bodies of the Russian Federation, government bodies of the subject of the federation of RF or the local government bodies the accounting reports and other documents, a list as defined by the Government of Russian Federation, by the bodies of the executive government of the subject of federation or the local government bodies.

The unitary company has to publicize its reporting in cases listed in the federal laws and other normative-legal acts of the RF. The unitary company should keep auditing conclusion, conclusions of the bodies of the state or municipal financial control.

1.5 Periodicity of the internal and external scrutiny

- *How regular and timely are external and internal audit?*

Under the existing law, the superintendent of the budget funds performs audit for their purpose and rational use, and presents findings in the governmental Financial Directorate Quarterly Report by the middle of each month which follows the reporting period. Users of the budget funds are obliged, quarterly, by the 10th day of each month, following the reporting period, to present the act of collation, and report to the superintendent on use of budget funds according to their assigned

purpose. The municipal body of the financial scrutiny (the control-inspectional directorate) conducts six to eight inspections annually.

2. HUMAN RESOURCE DEVELOPMENT

- *What qualifications do internal and external auditors possess?*

Requirements for the internal and governmental auditors/inspectors are formed within the governmental structure: the Ministry of Finance of the Russian Federation. Required qualifications an advanced degree in economics and professional education. Also, the structures of the Ministry of Finance of the Russian Federation conduct the certification of the financial staff (once every five years).

- *How are the independence and objectivity of the internal and external auditors assured?*

Municipal auditors and inspectors are found to be in a more vulnerable situation as compared to state inspectors. The efficiency of financial audit is directly dependent on the volume of the financing of the inspection bodies, as are their measures of impact. In practice, within the framework of the current law, the financing of the auditing/inspectional bodies comes from the local budget, and measures of impact are not written clearly in the legislation. Owing to the permanent deficit of the local budgets, the human resources of the financial auditors are permanently weakened, and take place according to the fluctuation of manpower.

- *Is their training adequate to apply European accounting standards and also modern concepts of value for money?*

Within the Union of Municipal Control-Inspectional Bodies of the Russian Federation, these programs take place, however, the representatives of interviewed municipal constituencies, are not financially capable of participating in this training.

- *Do they belong to professional associations capable of updating knowledge and standards?*

Currently the relevant organization is the Union of Municipal Control-Inspectional Bodies of the Russian Federation. The Audit Chamber of the Russian Federation develops the audit and inspectional standards, and methodic recommendations (Federal Law on Audit Chamber of the RF, from January 11, 1995, No. 4-FZ, in the edition of the Federal Law from April 12, 2007, No. 49-FZ). Representatives

of the researched municipal constituencies do not take part in the activities of the Union.

- *Are there training institutions that are able to update and upgrade professional standards?*

In the Russian Federation there are the training institutes which are able to update and upgrade professional standards, but the researched municipal constituencies do not use their services.

CONCLUSIONS

Within the framework of the conducted research, original hypotheses were confirmed.

The system of municipal financial scrutiny is in the formation stage.

The increase of infringements on budget legislation takes place because of lack of written responsibility for infringements in the legislation.

A trend towards an increase in the volume of infringements, not execution of the requirements (prescriptions, notions) of the inspectional (audit) body of the local government, is also noted. This contributes to the increase of the financial losses of local budgets.

The reason for this trend is the lack of legislative insurance of financial scrutiny, regulating rights, obligations, and responsibilities of the body, executing budget, superintendent of budget funds for the infringements of the acting legislation. Public access to information on audit results should be improved.

Forming the unique methodological and methodical basis of ensuring municipal financial scrutiny is necessary to develop standards for audit activities, legislate and classify of financial infringements and sanctions, introduce unified forms of reporting for control bodies, monitor the impact of audit activities on the basis of its unique informational base, and introduce an audit of efficiency with appropriate criteria and indicators.

NOTES

- ¹ Article 151 of the Budget Code of the Russian Federation.
- ² Article 153, p.1 of the Budget Code of the Russian Federation.
- ³ Article 265 of the Budget Code of the Russian Federation.
- ⁴ Article 266 of the Budget Code of the Russian Federation.
- ⁵ Article 267 of the Budget Code of Russian Federation.
- ⁶ Article 268 of the Budget Code of Russian Federation.
- ⁷ Article 157, p. 2.1 of the Budget Code of Russian Federation.
- ⁸ Constitution of the Russian Federation, Article 12: Local government within the limits of their credentials are independent (budget and financial management are the credentials of local government). Local government bodies are not included in the system of state government.
- ⁹ Article 117 p. 8 of the Budget Code of the Russian Federation.
- ¹⁰ Article 270 of the Budget Code of the Russian Federation.
- ¹¹ Article 269 of the Budget Code of the Russian Federation.
- ¹² Article 151, p. 7 of the Budget Code of the Russian Federation.
- ¹³ Article 153, p. 1 of the Budget Code of the Russian Federation.
- ¹⁴ Article 168, p. 3 of the Budget Code of the Russian Federation.
- ¹⁵ Federal Law on Audit Activity from August 7, 2001, No. 119-FZ; in edition from November 3, 2006, No. 183-FZ.
- ¹⁶ Article 34, p. 1, Article 38 of the Federal Law on General Principles of the Organization of Local Government in the Russian Federation from October 6, 2003, No. 131-FZ; from May 10, 2007, No. 69-FZ.
- ¹⁷ Article 117, p. 8 of the Budget Code of the Russian Federation.
- ¹⁸ Article 154 of the Budget Code of the Russian Federation.
- ¹⁹ Article 20, p. 1, Federal Law on State and Municipal Unitary Companies, from November 14, 2002, No. 161-FZ (in edition from December 8, 2003, No. 169-FZ, with amendments, and introduced into the Federal Law from December 18, 2006, No. 231-FZ).
- ²⁰ Article 26 Federal Law on State and Municipal Unitary Companies from November 14, 2002 No. 161-FZ.
- ²¹ Federal Law on Audit Activity from August 7, 2001, No. 119-FZ and in edition of the Federal Law from November 3, 2006, No. 183-FZ.

Report on the Control System
in Serbian Local Authorities:
“Audit Study” Serbia

Života Antić

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INTRODUCTION

International audit standards define *control in the public sector* as control policy and procedures accepted by local self-government in helping to achieve its goals in providing order and effectiveness within local self-governments. This includes compliance with management policy, maintaining fund integrity, prevention of criminal acts and mistakes (and their disclosure), complete and accurate accounting data, and creating reliable information in due time.

For this kind of control, as per international audit standards, a functioning control environment, control procedures, and accounting systems are required.

Factors that influence the control environment in local self-government are:

- 1) Executive local authority,
- 2) City and municipal councils,
- 3) City and municipal assemblies,
- 4) Managing boards and their respective bodies,
- 5) Local self-government organizational structures,
- 6) Determination of authorities and responsibilities of executive authority and its working bodies,
- 7) Human resources policy,
- 8) Inspection bodies.

Control procedures in local self-government are regulated by a legal framework, and are conducted in accordance with the organization of this service and its independence, which relies, above all, on the controller's expertise as well as the readiness of the executive authority to establish "real" control, "real" reporting, and the "real" independence of that service.

The third component in the system of internal controls is the accounting system.

According to international audit standards, an accounting system represents the expenditures list and data of a legal entity by which business acts are elaborated as a basis for conducting an accounting database.

This system identifies, collects, analyzes, calculates, classifies, notes, summarizes, and reports on business changes and other acts/procurements and payments, sales and revenues, employee earnings, and other financial transactions.

The accounting system is also regulated by a legal framework and is adjusted on a daily basis with international accounting standards of audit.

1. NORMATIVE REGULATIONS

1.1 Comment on the Law on Local Self-government

By articles regarding the Law on Local Self-government published in the *Official Gazette of Republic of Serbia*, No. 9/2002, 33/2004, 135/2004, and 62/2006, the right of citizens to local self-government shall be exercised directly and through freely elected representatives, by administering public affairs in the direct, collective, and general interests of the local population.

Local self-government shall be realized in municipalities, towns, and the city of Belgrade.

The local self-government unit is financed from original and shared revenues, as determined by this law, as well as from transfers.

Of the local self-government unit, the municipality is the principal territorial unit in which local self-government is realized. The municipality shall, by statute or other general acts, specify the manner, conditions, and forms of performing tasks within the scope of its primary jurisdiction.

The municipality must establish inspection services and perform inspection supervision over the enforcement of regulations and other general acts within municipal jurisdiction.

A city is defined as a territorial unit of local self-government, determined by law, comprising two or more urban municipalities.

The city is *also* required to establish inspection services and perform inspection supervision over the enforcement of regulations and other general acts within city jurisdiction.

Funds required for financing original and delegated functions of the local self-government unit shall be provided from the budget of the local self-government unit. Budgetary funds of the local self-government unit are provided from original and shared public revenues and from transfers from the budget of the state, in accordance with the law.

A local self-government unit decides on the amount of funds necessary for the performance of its activities, in accordance with the law.

The beneficiaries of the budget shall, upon the request of the bodies of the local self-government unit, and at least once a year, submit a report on their work, the implementation of their programs, and the utilization of funds from the budget.

The assembly of the local self-government unit are entitled to initiate proceedings before the competent Constitutional Court for appraising the constitutionality of a law and/or the constitutionality or legality of other regulations or general acts, should it deem they violate the rights of the local self-government unit as provided by the Constitution and the law.

A local self-government unit may appoint a civil defender (ombudsman) to protect collective and individual rights and citizens' interests by overall control of the work of the administration and public services.

The administration of the local self-government unit and other public services provide records and information to the civil defender, which is relevant to the performance of his/her authorized activities, upon his/her request.

1.2 Comment on the Law on the Local Government Finance

Multiple articles regarding the Law on Local Government Finance, from the *Official Gazette of Republic of Serbia*, No. 62/2006, regulate the financing of municipalities, cities, and the capital city of Belgrade when performing original and delegated functions.

All local government unit revenues are general revenues of the local government unit budget and can be used for any purpose authorized by law and provided for in an adopted budget of the local government unit, apart from those revenues of which the purpose is already set by law.

Local government units are entitled to the following original revenues generated on its territory, as follows:

- 1) property tax, apart from the tax on transfer of absolute rights and gift and inheritance tax,
- 2) local administrative fees,
- 3) local communal fees,
- 4) sojourn fees,
- 5) construction land-use charge,
- 6) construction land-development charge,
- 7) charges for the protection and improvement of the environment,
- 8) proceedings from concession agreements for providing utility services and proceedings from other concession agreements entered into by local government units in accordance with the law,
- 9) fines resulting from misdemeanor proceedings following the offence prescribed by the respective by law of the local government unit assembly, as well as the property interests withdrawn in the course of such proceedings,
- 10) revenues from the rental or lease of state-owned, immovable property used by local government units and their indirect budget beneficiaries,
- 11) revenues from the sale of movable property used by local government units and their indirect budget beneficiaries,

- 12) revenues generated through the activities of municipal bodies and organizations of the local government unit,
- 13) interest accrued on budget funds owned by the local government unit,
- 14) revenues from donations to the local government unit,
- 15) revenues from the self-contribution fee,
- 16) other revenues determined by law.

Additionally, there are revenues from other levels of government, as follows:

- 1) Shared tax revenues from personal income tax, coming from the income from agriculture and forestry, private business, real estate, leasing movables, personal insurance, a 40-percent share of the income tax paid according to the employee's place of residence, other revenues in line with the law and tax on inheritance and gifts, and tax on the transfer of absolute rights.
- 2) Transfers (non-categorical or non-conditional) for equalization, compensation, general transfer, transitional transfer, block transfer, categorical transfer, or conditional transfer.

Local government units alone *shall set, collect, and control the public revenues* referred to above (from 1 to 16) as of January 1, 2007.

Additionally, a local government unit can conscribe employees from the Ministry of Finance and Tax Administration for performing operations, as per the previous paragraph, as of December 1, 2006, though this has yet to occur.

This law also prescribes that local government units can execute a contract on technical and other assistance with the Ministry of Finance and Tax Administration for the operations referred to above (from 1 to 16) for a fee that will be set by the Tax Administration. Some local self-government units have done so, while those who want to perform this task by themselves don't have the funds, because they are not determined in the Budget of the Republic of Serbia.

Local self-government units expect significant funds from their departments from the setting, collecting, and controlling of original revenues on their territory, in order to finance their needs, as they have already planned for these revenues in their budgets.

Also, the urgent adoption of changes and amendments to the law on tax procedures and tax administrations must be accomplished.

The Committee on Local Self-government and Local Finances is making great efforts in solving the problem of the workings of these departments.

1.3 Comment on the Law on the Budget Systems

Multiple articles regarding the Law on Budget Systems from the *Official Gazette of the Republic of Serbia*, No 9/2002, 62/2006, and 85/2006, regulate the planning, preparation, and adoption of the Budget of the Republic of Serbia, as well as the budgets of territorial autonomies and local self-government; the law also regulates the control and audit of the Budget of the Republic of Serbia and local governments, as well as the control and audit of public institutions and other indirect beneficiaries of budget funds, public enterprises, and legal entities founded by public enterprises, i.e., legal entities where the Republic, i.e., local governments directly or indirectly control more than 50 percent of capital or more than 50 percent of votes in the Steering Board.

The Minister of Finance is responsible for the execution of the State Budget. The government reports to the National Assembly on the execution of the State Budget. The competent executive body of each local government reports to the Local Assembly on the execution of their local budgets.

The primary entity responsible for financial control harmonization, financial management and control, and internal audit was established as a part of the Ministry of Finance.

The functions of this entity are:

- 1) Central harmonization and coordination of internal financial control methodologies in the public sector;
- 2) Defining internal control standards in accordance with internationally recognized standards;
- 3) Defining common criteria regarding the arrangement and procedures within the public-sector internal audit;
- 4) Developing methodological guidance and financial-management manuals;
- 5) Professional development and certification of internal auditors, and the monitoring of their work;
- 6) Training public sector managers and staff in financial management and control, in accordance with internationally accepted standards;
- 7) Internal audit of budget beneficiaries, organizations, and enterprises, i.e., legal entities mentioned in first line of Article 3;
- 8) Internal audit of budget beneficiaries for projects which are co-financed by the European Union.

The Minister of Finance determines standards, criteria for organization, and methodological guidance for the closer regulation of these functions.

Internal control shall be organized as a system of procedures and responsibilities of all the persons involved in the financial and operational processes of the direct and indirect budget beneficiaries and organizations for compulsory social insurance.

This law regulates internal audit. The Minister of Finance determines the direct beneficiaries of budget funds, and determines common criteria for the organization and procedures of internal audit, based on direct beneficiaries of budget funds and organizations for compulsory social insurance that closely determine organization and procedures of internal audit, which has not been done until now.

Budgetary inspection is also regulated by this law. There are state and local budgetary inspections with the purpose of carrying out inspection of the budget beneficiaries, organizations for compulsory social insurance, and public enterprises founded by the state and local governments.

The function of budget inspection complies with current legal controls in the area of material and financial transactions, as well as the purposeful and legal use of funds by budget beneficiaries, organizations, enterprises, and/or legal entities where the state, i.e., local governments directly control more than 50 percent of the capital, or more than 50 percent of the votes in the Board of Directors, as well as other legal entities in which public funds are more than 50 percent of the total revenue.

The budget inspectors report on inspections conducted, their findings, and recommendations to the minister, who submits it to the National Assembly twice a year; local budget inspection submits reports to the local government assembly on the performance of inspection control of budget beneficiaries, in order to undertake certain measures within their competency.

According to this law, the final statements of the state and local government budgets, and financial plans of organizations for compulsory social insurance, shall be subject to external audit.

This law also regulates fines for offences that are estimated between RSD 5,000 and RSD 50,000 for the person responsible, and for crimes between RSD 30,000 and RSD 300,000.

1.4 Comment on the Law on Accounting and Audit (*Official Gazette of the Republic of Serbia*, No 46/2006)

This law governs the requirements for and manner of keeping books of account, recognition and assessment of assets and liabilities, income and expenditures, preparation, presentation, submission, and disclosure of financial statements, as well as the requirements for and manner of auditing financial statements, and internal audit.

The provisions of this law apply to enterprises, cooperatives, banks and other financial organizations, insurance organizations, leasing companies, pension funds, stocks

exchanges and stockbrokers, and individuals independently performing economic activity for the purpose of gaining profit.

The provisions of this law do not apply to budgets and beneficiaries of budgetary funds, churches and religious communities, or organizations for social protection. These entities keep their books according to the Law on Budget Systems, and acts based on this law.

This law also defines internal audit so that a legal entity can establish, and in certain cases, is *obliged* to establish, an internal auditor with the duty to audit, evaluate, and to assess the adequacy and effectiveness of current accounting systems, and that the systems of internal controllers are in accordance with the law.

Audit of annual financial statements are obligatory for medium and large legal entities.

The audit of annual financial statements is conducted in accordance with this law and in accordance with the International Standards of Auditing (ISA).

All entities subject to auditing shall disclose their balance sheet, income statement, cash flow statement, statement of changes in equity, and notes to the financial statements, accompanied by an auditor's opinion by September 30 of the current year, at the latest, via publishing the results in the media or on a website.

This law does not regulate the authority for the interpretation of professional regulations when it is applied on the territory of the Republic of Serbia. The need for interpretation of professional regulations (such as the IAS and IFRS) comes as a result of their complexity, specific application conditions in the Republic of Serbia, as well as a result of the fact that incomes and expenditures, determined based on professional regulations, are used for setting the tax obligations of legal entities, all regulated by the law on company income tax.

This law does not name any precise vocation (profession) that is required for the persons who are in charge of keeping books of account and preparing financial statements. This is because those qualified within the accounting professions (accountant, independent accountant, or certified accountant), don't have qualifications defined within this law.

This means that keeping books of account can be given to a person who is not formally qualified.

This law defines the obligation of preparing consolidated financial statements. Legal entities which have control over one or more legal entities, according to this law, and according to the IAS/IFRS, are obliged to prepare, present, submit, and disclose consolidated financial statements.

This kind of request is not fully in compliance with the IAS/IFRS. There are potential cases which exert control over the entity but are not obligated to prepare consolidated financial reports.

1.5 Comment on the Law on Business Entities (*Official Gazette of Republic of Serbia*, No. 107/2005)

Article 29 of the Accounting Law delineates the problems of internal audit. A legal entity can perform internal audit, while in cases defined by the law on business entities, a legal entity is *obliged* to perform internal audit.

1.6 Comment on Law on the State Audit Institution (*Official Gazette of Republic of Serbia*, No. 101/2005)

This law stipulates the establishment, legal status, mandate, organization, and operating methods of the State Audit Institution (SAI) and the other issues of importance for the functioning of this institution, as well as the rights and obligations of the subjects of its audit.

This SAI is an autonomous and independent state authority that is accountable to the National Assembly of the Republic of Serbia.

The scope of mandate and the task of this institution are to plan and perform the audit.

Subjects of the audit are the direct and indirect beneficiaries of the budget funds of the state, autonomous provinces, and municipalities, according to rules which regulate budget systems, and systems of public revenues and expenditures, organizations of mandatory social insurance, budget funds founded by separate law or bylaw, the National Bank of Serbia (in regard to its operations with the state), public companies, commercial societies, other legal entities where the state or local authorities possess a share in the capital, and other subjects that utilize the funds of the state or local authority.

The president of the SAI is both the General State Auditor and the manager of the SAI.

The Supreme State Auditor is appointed and dismissed by the president of the SAI for the term of six years.

State auditors conduct the actual auditing.

Titles of auditors in this realm are State Auditor and Certified State Auditor.

The exam for acquiring the title of the State Auditor or the Certified State Auditor, are taken according to a program approved by the ministry responsible for the state's administration affairs, and on the recommendation of the Council of the Institution.

The SAI reports to the assembly by submitting:

- 1) an annual activities report,

- 2) a special report during the year;
- 3) audit report on the annual statements of the State Budget, finalized financial plans of organizations of social insurance, and consolidated financial statements of the Republic of Serbia.

This law, adopted at the end of 2005, created an extremely important institution, with a view to balance the relationships between the legal and executive authorities.

1.7 Comment on the Law on Tax Procedure and Tax Administration (*Official Gazette of the the Republic of Serbia* No. 80/2002... 63/2006)

By adopting this law, a unique way of assessment, collecting, and controlling was determined for all public revenues, as well as the tax procedure, rights, and obligations of tax payers, as well as their restrictions. This law also regulates tax offenses and violations.

This law precisely states that within the Ministry of Finance, the following bodies are established: tax administration, tax police, and tax inspection.

Tax assessment is accomplished by the taxpayer himself, or by the tax administration via a tax decision.

Tax collection is regular, and is performed when tax liability is due. Its collection is enforced when the due tax liability has not been settled.

Tax control, in accordance with this law, can be performed as office controls or a field control, and can be performed as an activity undertaken to reveal tax criminality. All acts are performed by tax administration on the basis of an annual plan.

Within office control, the tax administration verifies the accuracy, completeness, and legal basis of the data provided in tax returns, tax balances, accounting statements, and other statements kept by, or at disposal of, the tax administration.

Field control is undertaken on the premises of the taxpayer or on another location determined by manager of the organizational unit of the tax administration where the taxpayer is registered.

Detection of tax-related criminal offenses is performed by the tax police, and those are:

- 1) entire or partial evasion of payment of tax and non-payment of withholding tax;
- 2) production or submission of counterfeit documents relevant to taxation;
- 3) endangering tax collection and tax control;
- 4) disruption or obstruction of any tax official during the tax procedure;

- 5) illegal trade in goods;
- 6) illegal warehousing of goods on the premises, which are not registered for appropriate business purposes, or lack proper documentation of origin and paid tax; in both cases the goods are to be seized.

The Law on Tax Procedures and Tax Administration defines tax violations for not submitting the appropriate tax return on time, and for assessing smaller amounts of tax in returns.

The tax administration in Serbia works through its centers in Belgrade, Novi Sad, Kragujevac, and Nis, with branches in all local self-governments.

The law on local government finance allows local self-governments to establish departments for the setting and collection of public revenues on its territory, as well as for the specific original revenues that are described in the text of this law.

This is the beginning of devolution of responsibilities to local self-government for setting, collecting, and controlling the original revenues on their own territory. During upcoming years, through 2010, local self-governments will take over more tasks from the tax administration except for tasks performed by the Tax Police.

1.8 Comment on the Law on General Administrative Procedure (*Official Gazette of the Republic of Serbia*, No. 33/1997... 21/2)

State authorities and local self-government authorities proceed in compliance with the provisions of this law, directly applying the legal regulations, when deciding administrative matters on the rights, obligations, or legal interests of a private person, legal personality, or other party.

This law states that a state authority, a local self-government authority, institutions, and other legal personalities proceeding in administrative matters shall decide in accordance with the law and other regulations.

For example, budget inspection and auditing has rights to control the budgetary beneficiaries, but only with a respect to these principles:

- The principle of legality (according to the law and other rules);
- The principle of protection of citizens' rights and the protection of public interest (to enable parties to protect and realize their rights and legal interests as easily as possible);
- The principle of efficiency (to provide for efficient and quality realization and protection of rights and legal interests);
- The principle of truth (all facts and circumstances are established accurately and

in their entirety throughout the procedure);

- The principle of listening to the party (prior to passing a decision, the party must be asked to make a statement on the facts and circumstances of significance for making a lawful decision);
- The principle of assessment of evidence;
- The principle of independence in decision-making (when the decision is made within the framework of authorization as determined by the law or other regulations);
- The principle of two instances (the party is entitled to appeal against a decision made in the first instance. An appeal against a decision made in second instance, however, is not permitted);
- The principle of entering into effect (a decision against which appeal is not permitted);
- The principle of cost-efficiency of the procedure (the procedure shall be conducted without delay and at the lowest possible cost);
- The principle of assisting the party (help for raising the profile of the party and other participants);
- The use of appropriate language and script within the procedure (via an interpreter).

This law stipulates that a record must be drawn up on any oral hearing or other major action during the procedure, as well as on significant verbal statements of the parties or third persons throughout the procedure.

The authority competent for decision-making issues a decision on any administrative matter that is the subject of the audit, based on salient facts, as determined during the course of the procedure.

The right for appeal is also regulated by this law, in first instance. The law states that, in second instance of an appeal against an issued decision, the responsible body in charge will make decision.

1.9 Comment on the Law on Violations

(Official Gazette of the Republic of Serbia, No. 101/2005)

The law on violations, from the control perspective, regulates:

- conditions for violation responsibility,
- conditions for use of regulations and for violations sanction,

- the system of sanctions,
- violation procedure,
- procedure of violations' decision execution,
- organization and work of the body in charge of violations.

This law states that any law or regulation which was in effect at the time of the violation will be applied, and if the law is changed later, the law which is most applicable to the violator will be applied.

This law defines that provisions on violations are in effect on the territory of the Republic of Serbia when they are prescribed by law or by law, or on the territory of an autonomous province and local self-government.

The law defines legal sanctions, such as penalties, warnings, protective measures, fines, or even prison sentences. The law can prescribe any of these penalties.

The law states that the violation inspection procedure is initiated by the authorized institution or party in the audit process. The authorized institutions include: administrative institutions, inspectors, the public prosecutor, and other institutions and organizations having public authority over direct execution or supervising the execution of the rules regulating the violations.

The law that regulates that violation procedure cannot be applied if more than one year passed from the instance the violation occurred. For violations in the field of public revenues, customs, international trade, and foreign exchange the regulations can be, by a specific law, applicable for a longer period, but not longer than five years.

The law that regulates the violation procedure, in the first case, is conducted by a magistrate.

The violation procedure, in the second case, will be conducted by the Board of Judges for Violations.

If the law that regulates the first case, decides that there are no grounds for undertaking a violation procedure, the request will be rejected.

The law regulates that a violation procedure concludes with the decision on any violation.

By decision regarding the violation, the procedure is concluded, or the defendant is declared guilty for a specific violation.

The law regulates the appeal against any decision brought in the first case, which must be submitted to the responsible authority. The appeal must be submitted within eight days from the day of the verbally stated decision or from the day of decision delivery.

The law also regulates who can submit an appeal. The appeal can be submitted by a defendant or person who is submitting the request.

1.10 Comment on the Law on Economic Offenses (*Official Gazette of the Republic of Serbia*, No. 101/2005)

The Law on Economic Offenses regulates responsibilities and sanctions for economic offenses in order to protect the legal order in the field of economic and financial operations, defines general terms and principles for imposing sanctions for economic offenses, sanctions system, as well as the procedure which regulates responsibility and imposes sanctions for perpetrators of the economic offense.

This law has articles pertaining to the responsibility and sanctions for economic offenses, according to the republic, as well as provincial laws and regulations.

The law states that responsibility for any economic offense can be committed by any legal entity or person in charge of that legal entity. A legal entity is considered responsible for an economic offense if the offense occurred as a result of an action or supervisory neglect from the executive body or person in charge, or as a result of an action of another person authorized to operate on behalf of the legal entity.

The law regulates that personal responsibility for economic offenses don't end if the person stops working for the legal entity or other state body, or if bankruptcy is declared for that legal entity, or if it's impossible to impose sanctions on the legal entity, due to its dissolution.

The law states that for an economic offense, only a fine can be imposed. The statute of limitations occurs after three years have passed with an exception for international trade, customs, and foreign-exchange operations, for which that deadline extends to five years.

The law states that the expiration of sanctions applied occurs three years from the sanction's initiation.

The law states that the responsible court should be local and on the territory where the accused legal entity resides.

The report on the economic offense should then be submitted to the public prosecutor, in written or oral form. In the case of an oral report, the person who is reporting must be warned of the consequences of a false report. A written report will be made about the oral report, and in the case of a telephone report, an official note will be transcribed.

The procedure for economic offenses that appear in court shall be initiated by the public prosecutor.

If the public prosecutor doesn't initiate the procedure, or if he/she fail to prosecute, the complainant can initiate, or continue with the procedure against economic offense, by submitting a proposition for the realization of their legal request.

For economic violations committed by a legal entity or the person in charge of said legal entity, a unique procedure will be initiated and conducted.

The Court in the Republic of Serbia, and its autonomous provinces, in cases of economic violations, will proceed within their competent authority, as set by the state or by an autonomous law.

1.11 Comment on the Criminal Code (*Official Gazette of Republic of Serbia*, No. 85/2005 and 107/2005)

Because a criminal report is, by nature, an informal procedural act, the submission of the report has but an informational function regarding the criminal act, perpetrator, and evidence. The report only initiates the criminal procedure, and does not produce any legal consequences. Submitting a report does not initiate criminal procedure in every case. The local public prosecutor's office decides independently, according to available evidence, if the conditions are appropriate to initiate a criminal procedure. Giving up or withdrawing the report does not have any legal or procedural effect either.

According to the Criminal Code, all state bodies, territorial autonomies, local self-government bodies, public companies, and institutions are obliged to report on officially prosecuted criminal acts, of which they have information or which have come to their knowledge in some other way.

1.12 Comment on the Statute of the Cities

According to the Law on Local Self-government (*Official Gazette of the Republic of Serbia*, No. 62/2006) cities and municipalities are obliged to establish local offices for inspection and audit.

1.13 Comment on Regulation on Budgetary Accounting (*Official Gazette of the Republic of Serbia*, No. 125/03 and 12/2005)

This regulation states that budget beneficiaries and social insurance organizations, as well as beneficiaries of the state Health Insurance Office, define within their internal operations:

- organization of an accounting system,
- internal accounting control procedures,
- persons in charge of legality, accuracy, and creation of acts on economic changes,
- accounting documents' flow and deadlines for their delivery.

1.14 Comment on Regulations on Budget Inspection, Audit Authorizations, and Characteristics of Budget Inspection (*Official Gazette of the Republic of Serbia*, No. 10/2004)

This regulation sets forth ways of work, authorization, and the characteristics of budget inspection, as well as the legal protection during the inspection and audit procedure.

Budget inspection controls accounting books, reports, records, and other documentation held by budget beneficiaries with the objective of determining whether funds are spent according to law and for planned purposes.

1.15 Comment on the Regulations of the Authorized Auditors Chamber

The Law on Accounting and Audit, Article 51 (*Official Gazette of the Republic of Serbia*, No. 46/2006), regulates the establishment of the Authorized Auditors Chamber. The main goals for the chamber's establishment are: the improvement and development of the accounting and auditing profession, the implementation of international accounting and auditing regulations (and harmonization with those regulations), public- and individual-interest protection in this field, organizing and providing services in this field, organizing for exams certifying audit professionals, issuing and retracting licenses for financial report audit.

The chamber's bodies are: the Assembly, Council, Steering Committee, and Disciplinary Commission.

The Assembly and Council of Chamber created the following acts:

- the decision on Chamber Assembly constitution,
- the decision on operating according to ethical rules for professional accountants,
- the rulebook of conditions for becoming a member and membership's termination in the Chamber of Authorized Auditors,
- the rulebook on membership fees and its charges for the Chamber of Authorized Auditors,
- the rulebook on in the sign-in and register of the Chamber of Authorized Auditors,
- the rulebook on disciplinary procedures,
- the rulebook on the conditions and procedures for the exam which certifies the professional vocation of an authorized auditor or authorized internal auditor,
- the rulebook on continuous professional improvement and training,

- the rulebook on the conditions for issuing certificates for professional vocation of an authorized auditor or authorized internal auditor,
- the rulebook on the validation of professional qualifications gained in foreign countries,
- the rulebook on the conditions for getting, extending, and revoking licenses from authorized auditors.

1.16 Comment on Internal Audit within Direct Users of Budgetary Funds

The Law on the Budgetary System, published in the *Official Gazette of the Republic of Serbia*, No. 85/06, Article 66a, states that the direct and indirect budget beneficiaries, social insurance organizations, and public companies established by the state or local authority, legal persons in which the state or local authority has direct or indirect control over more than 50 percent of capital or more than 50 percent of votes in the executive board, as well as in other legal persons in which public funds are more than 50 percent of total revenues, *create an internal control system for all transactions on revenue and expenditure accounts, account of financial resources, liabilities, financing account, and managing state property.*

The internal control system consists of a network, with goals to ensure:

- 1) implementation of law, rules, regulations, and procedures,
- 2) successful operations,
- 3) economic and efficient spending, according to their plan,
- 4) fund saving and investment from loses, including fraud,
- 5) integrity and reliability of information, accounts, and data.

Internal control is organized as a system of procedures and responsibility of all those involved in the financial and economic processes of the direct and indirect budget beneficiaries and social insurance organizations.

The establishment of secured and efficient internal control for all decisions about financial management and control is the responsibility of the director of the direct or indirect budget beneficiaries, the director of social insurance organizations, the director of a public company, or legal entity over which the state, or local government have direct or indirect control of more than 50 percent of the capital or more than 50 percent of votes on the executive board, as well as directors in other legal entities in which public funds are more than 50 percent of their total revenues.

1.17 Comment on the Draft Law on Internal Financial Control of the European Agency for Reconstruction and Treasury Department of the Ministry of Finance

This draft law was presented during the meeting of the Committee on Local Self-government and Local Finances and of towns and municipalities on May 28, 2007, and will be sent to the government of the Republic of Serbia.

This law regulates the system and procedures of the functioning of public internal financial control in direct and indirect budget beneficiaries of the state, autonomous provinces, local self-governments, state health insurance offices, state pension and disability funds, the National Employment Service, public enterprises and legal entities founded by such enterprises, and/or legal entities in which the state has direct or indirect control over more than 50 percent of the capital or more than 50 percent of the votes in the management, including the responsibility of the heads of organizations for the functioning of internal financial control as is provided in this law.

The goal of this law is:

- 1) to establish a legal framework for the development of public internal financial control;
- 2) to establish a basis for the development of the by-laws needed for the implementation of a primary law;
- 3) to establish a legal framework for future negotiations about complying with the request of Chapter 32 entitled, Internal Financial Control in the Public Sector within the *acquis communautaire* of the EU;
- 4) to improve financial control in public funds spending;
- 5) to initiate the development of the decentralized responsibility of managing structures;
- 6) to make access and control easier for the government over donors' funds, including instruments for the pre-accession (IPA) funds of the European Commission.

Directives and standards used in this law are:

- 1) directives for the standards of internal control in the public sector of the International Organization of Supreme Audit Institutions (INTOSAI);
- 2) standards and directives for internal audit in the public sector of the International Organization of Supreme Audit Institutions (INTOSAI) and the Internal Auditors Institute (ITA);

- 3) legal solutions from other relevant countries;
- 4) the existing legal and institutional framework in Serbia.

The draft law contains:

- 1) definitions,
- 2) an internal control system,
- 3) the responsibility for the establishment of internal control system within organizations,
- 4) objectives of financial management and control,
- 5) internal control standards,
- 6) reporting,
- 7) the authority of heads of organizations,
- 8) the responsibility for heads of finances in organization.

2. IMPLEMENTATION OF LEGAL REGULATIONS IN LOCAL SELF-GOVERNMENT

2.1 Internal Control within the Users of Budgetary Funds

Until now, according to the Law on the Budgetary System, the Minister of Finance created a rulebook for the determination of direct budget beneficiaries who form the service of internal controllers and the common organization criteria and procedure of internal control of budget beneficiaries and social-insurance organizations. According to changes and amendments to the Law on Budgetary Systems, the minister will make a new rulebook and also new acts that will regulate standards, organizational criteria, and methodological guides; and will closely regulate internal control operations.

2.1.1 Instructions for the Local Authority Treasury, When Used for Internal Control

According to the existing rulebook for the determination of direct budget beneficiaries who form the service of internal controllers and the common organization criteria and procedure of internal control of budget beneficiaries and social insurance organizations, municipalities and cities are regulated by internal control in different according to their

individual internal acts. Based on research, it is stated that the city of Niš, according to the common organization criteria and the procedure of internal control of direct budget beneficiaries, through an internal act known as Instructions for the City Treasury, closely regulates the organization and procedure for control, based on Articles 6, 7, and 42 of the Decision on the City of Niš's City Departments (*Official Gazette of the City of Niš*, No. 97/04, 22/05, and 40/06). This model has been accepted by other municipalities as well.

Within these guidelines, aside from the procedure for budget realization, internal control over all financial transactions is anticipated.

The internal control over registering and the change of appropriation procedures in local self-government

Any request for a change in appropriation must be submitted by the direct budget beneficiary, when the appropriation registered in the treasury has changed.

The Budget Department's internal control, according to requests, first conduct a control of the available appropriation in the following way:

Amount of appropriation plus or minus the changes of appropriation, minus unpaid overtaken liabilities, minus expenditures.

An approved request is passed to the Treasury Department, where the request is registered, separately for each budget beneficiary, with one copy going to those who submitted the request.

Internal control of processes concerning any budget-realization plan, and quotas within local self-government

Budget-realization plans and quotas have the following objectives:

- 1) obedience to the Law on Budgetary Systems and the city's decision on the budget,
- 2) a creation for the basis for planning and managing cash flow,
- 3) the control of excessive spending by making reservations within appropriations and quotas before purchasing goods and services and before bill's maturity.

Control of the processes concerning budget-realization plans and quotas is conducted with the executor of the Treasury Department for Finances, according to adopted plans and decisions for the internally controlled budget of that year.

Control includes inspection of the available three months; quota, which is executed according to the following formula:

Operating (current) quota plus unspent quota from previous period plus minus quota change minus unpaid overtaken liabilities minus expenditures.

Internal control of assuming the liabilities of budgetary users

Carrying out the process of assuming liabilities means reserving the budgetary appropriations and quotas from the direct budget beneficiaries, according to unrealized contracts or other obligatory legal actions who will, in their moment of engagement, create a direct or future cash expenditure.

The authority for expenditures is set through control and:

- 1) request preparation for assuming liabilities is submitted by the direct budget beneficiaries;
- 2) request notarization for this function is done by the direct budget beneficiary;
- 3) request approval is executed by the Finance Department, the Budget Department, and the Treasury.

The request for the assumption of liabilities is filed for all kinds of procurements and payments, except in such cases as: when the total amount of liabilities is RSD 200,000,00 or less, when procurement is done under an urgent, express procedure (according to the Law on Public Procurement), or when it falls within an economic classification which does not require the assumption of liabilities.

The following documentation is submitted with the request:

- 1) evidence for obedience to the Law on Public Procurement;
- 2) an explanation for the assumption of liabilities;
- 3) a draft contract or documents on the assignment of a payment schedule.

Assumed liabilities higher than those planned by the budget or against the Law on the Budgetary System cannot be executed by the consolidated treasury account.

Internal control of salary and fee payment to the budgetary users/employees within city administrative offices, public companies, institutions, sport organizations, and other users of city and municipality budgets

This control is accomplished through the classification structure of employees, the number of employees, and a coefficient for individual places of work, and: salaries, bonuses and charges for employees, social contributions paid by the employer, payments in kind, social contributions of employees, and employee charges.

Internal control of fund transfer for capital investments' payment from the city and municipality budget

This control consists of checking if each payment is based on the Decision on the City Budget, and if the original accounting documentation is accurate, complete, calculated

properly, legal, and abiding by the monthly plan. It also checks if capital investments are made based on the decision of the body in charge, and in accordance with the procedures and rules regulated by the Law on Public Procurement.

Internal control of reports on indirect users realized revenues

This control consists of checking revenues from charges for provided services, revenues from subsidies, revenues from donations, transfers, and other own revenues.

Internal control of direct and indirect budgetary-fund user payment and fund transfers

This control consists of checking if each payment is made according to the Decision on the City Budget, and whether the original accounting documentation is accurate, complete, calculated properly, legal and abides by the three-month plan, and with the procedures and rules regulated by the Law on Public Procurement and the Law on Budgetary Systems.

Internal control of current budgetary reserve fund's use

This control consists of checking whether the current budgetary reserve funds have been used according to Article 48 of the Law on Budgetary Systems.

Internal control of permanent budgetary-reserve's fund use

This control consists of checking whether the permanent budgetary reserve's funds have been used according to Article 49 of the Law on Budgetary System.

2.2 Internal Audit Within the Budgetary Fund Users

2.2.1 Work of Budgetary Inspection and Audit Division

—The Internal Audit Department within the Ministry of Finance

The Budgetary Inspection and Audit Division perform administrative and supervision tasks, and other tasks as a separate internal unit within the Ministry of Finance.

The tasks for budgetary inspection and audit are defined in Articles 22, 25, and Articles 64-73 of the rule book on the internal organization and systematization of working places within the Ministry of Finance.

Within the Budgetary Inspection and Audit Division there are two additional departments: the Department for Budget Control, and the Department for Internal Audit.

The tasks of budgetary inspection and audit division executed according to the Law on Budgetary Systems, the Law on Public Administration, the Law on General

Administrative Procedure and Instruction on Work and Authority of Budget Inspection and Audit, as well as on the usual characteristics of budgetary inspection.

During the inspection and audit process, all effective laws are used for regulation of the material-financial functioning and the legal and already-planned mode of spending the funds.

2.2.2 Work of Division for Violations Proceedings of Secondary Jurisdiction

The Division for Violations Proceedings of secondary jurisdiction is responsible for tasks of conducting the violations procedure and making decisions on violation in second jurisdiction which break rules set from the Ministry regarding appeals for decisions made in first jurisdiction, setting facts' status, as well as updating new rules in these issues; the discussion of open questions; the following the violations procedure; and maintaining a data base of expenditure and legal practices.

2.2.3 Project Center for Control Planning and Implementation Promotion

This center is in charge of assignments related to the improvement of control planning and implementation of all the projects within the appropriate ministries.

2.2.4 Internal Audit of Banks

The internal auditing of banks is regulated by the Law on Banks (*Official Gazette of the Republic of Serbia*, No. 107/2005).

2.2.5 The Central Unit for Harmonization of Financial Control, Financial Management, Control and Internal Audit within the Ministry

The minister makes and brings acts that set standards, organization criteria, and methodological guidelines, and closely regulates the work of budget control and audit.

2.2.6 Exam Program for Gaining the Title of Authorized Internal Auditor

This program sets the topics for the exam that grants the professional title of Authorized Internal Auditor within the Chamber of Authorized Internal Auditors, as well as other topics related with the exam program for gaining the title.

The exam is organized according to a program consisting of:

- the role and activities of the internal auditor in management, risk determination, and control;
- internal audit performance;
- business analyses and information technologies;
- business management skills.

2.2.7 Internal Audit Performance Consisting of Auditor Assignment Performance, Specific Assignments, Supervision over Assignment Realization Results and Extension Means in Audit Performance

- The performance of an audit assignment consists of finding and implementing certain standards, recognition of potential fraud or theft, gathering the data and their relevant determination, completeness and efficiency, analyses and interpretation of gathered data, working papers' creation, draft and conclusions' creation and the performance of team members.
- The performance of specific assignments also consists of audit arrangements. These are the audit of third parties, contracted audit, audit of crucial ratios, audit of efficiency and efficiency of business, audit of informational technology, and audit of business in whole.
- Supervision of the results of performed assignments consists of the adequate supervision methods' determination of the results of the engagement and examination of the supervision plan and the results of realized engagement.
- In the context of audit, 'extension' means that an internal performance audit consists of choosing an appropriate sample, statistical analyses, gathering of data methods, an analytical survey, and the examination and map creation, etc.

The internal audit of budgetary fund users in local self-government—despite the fact that it represents the first level of supervision of audit subjects which use public funds, still hasn't managed to develop properly as an institution, and still is in its primacy within Serbia, and is only performed partially in the banking industry.

2.3 External Audit

- **The Chamber of Authorized Auditors** was established on November 15, 2006, in Belgrade.

Chamber affairs concern the implementation supervision of the IAS, IFRS, international audit standards, international standards for quality control, and the Ethics Code of professional accountants, supervision of the harmonization processes of accounting and auditing regulations with international professional regulations, programs' adoption, candidate trainings, exam organization, and certificate issuance for the granting of titles, and the continuous training of audit staff.

- **The chamber bodies** are the Assembly, Council, Steering Committee, and Disciplinary Commission.

The assembly adopts the statute, operating procedure, Ethics Code, and the appropriate instruction on disciplinary procedure of the chamber and others.

The *council* is an executive body of the *chamber* and consists of a president, vice president, one ministry representative, one representative of the National Bank of Serbia, one representative of the Association of Banks, one representative of the Commission for Securities, one university professor, and four authorized auditors working in audit firms.

The *steering committee* is in charge of supervision over the legality of *chamber* activities, examination of the annual activity report and financial reports, as well as other acts of the *chamber*, and performs other duties according to the law and statute of the *chamber*.

The *discipline commission* is the *chamber* body in charge of performing authorities as set by statute and operating procedures, for the disciplinary procedure, in the disciplinary measures' implementation, and other measures, by law.

- **Authorized Auditor and Authorized Internal Auditor**

The Law on Accounting and Audit, Article 4, regulates the professional title of Authorized Auditor and Authorized Internal Auditor.

An authorized auditor is an independent, professional person who performs audit and is responsible for the accuracy of the performed audit, audit-report creation, and submitting an auditor's opinion according to the IAS for audit and this law.

The professional title Authorized Internal Auditor can be gained by person who has a high-level education, working experience in external auditing of financial reports or internal auditing for at least three years, or five years in accounting, passed the

exam for gaining this title, and who has not been sentenced for criminal offenses that make him ineligible for this job.

An authorized internal auditor is a professional person who has gained the title according to this law.

- **Exam Program for Gaining the Title**

The Law on Accounting and Audit, Articles 5 and 6, state that the professional titles of Authorized Auditor and Authorized Internal Auditor are gained according to the program of the *chamber*.

A certificate is issued granting the recipient their title, according to this law.

- **Audit Performance**

The audit of annual financial statements is performed according to this law and the IAS, and is performed by authorized auditors who have a license for working on the duties of financial reports' audit, are licensed authorized auditors working in audit firms, and who are members of the *chamber*.

Authorized auditors opinion must be made according to IAS and can be positive, opinion with reserve, negative, or auditor can restrain opinion.

- **Granting and Revoking Licenses for Audit Performance**

The *chamber* grants, extends, and revokes licenses for performing financial statements' audit to authorized auditors and keeps a register of granted licenses for performing audit.

The *chamber*, with agreement from the Ministry of Finance, sets conditions for gaining, extending, and revoking licenses.

- **Audit Firms**

An audit firm is formed according to the law that regulates business entities, unless this law regulates it in another way.

The audit firm must fulfill the following conditions:

- authorized auditors or audit firms, as founders, must have a majority stake in executive rights;
- they must have the appropriate license for performing audit duties;
- the authorized auditors—the founders and authorized auditors—as employees are not under the control any other person or interest groups, according to the Ethics Code for professional accountants;

- they must have a specified number of of licensed, authorized auditors on staff;
- they must be a member of the chamber.

The request for issuing a license for audit performance is submitted to the Ministry of Finance by the firm's founder.

- **Supervision over Auditing Firms**

The supervision over auditing firms is performed by the Ministry of Finance through an authorized person only. This supervision is performed at least once a year. For a concluded supervision, a record shall be made in the audit firm.

If there are irregularities, their elimination is ordered by supervisor's decision and the appropriate measures prescribed by law are taken.

2.4 Budgetary Inspection

2.4.1 Founding a Local Office for Budgetary Inspection

According to the Law on Local Self-Government, municipalities and cities are responsible, through their bodies, and according to law and constitution, to form inspection services, which will be in charge of the inspection supervision over the carrying out of rules and other acts of their authority, and over the restricted budget funds' spending.

A statute states that, in municipalities and cities, an executive body is formed for local-budgetary inspection, according to law.

2.4.2 The Rulebook on Internal Organization and Employment Position Systematization of the Local Office for Budgetary Inspection

The rulebook regulates the number of employees, their educational level, work experience, and professional titles. This varies between cities and municipalities.

According to our research, the city of Niš has the most comprehensive rulebook. It stipulates that within budgetary inspection, degreed economists can work, as can certified accountants and auditors, authorized accountants, and auditors who have passed the professional exam allowing them to work in state bodies, and with PC literacy and a working experience of at least three years in the financial-control field.

2.4.3 Independency and Objectiveness of Budget Inspectors

The independence and objectiveness of the budget inspector is defined by the Rulebook on Work and Authorization of Budget Inspection, as an independent entity with special a position.

The updating of the education of Budget Inspectors is performed four times a year through seminars, tests, and other modes of education.

2.4.5 The Rulebook on Work and Authorization of Local Office for Budgetary Inspection

This rulebook regulates modes of work, authorizations of budgetary inspection, as well as legal protection within the process of budgetary inspection,.

The budgetary inspector performs the duties of the inspection of law implementation in financial and material operations, and the appropriate and legal spending of funds by budget beneficiaries, as per the Law on Budgetary Systems, Article 68 (*Official Gazette of the Republic of Serbia*, No. 9/2002 to 85/2006) for direct and indirect budget beneficiaries, public companies founded by a local authority, legal entities founded by public companies, or legal entities in which local authorities have direct or indirect control over more than 50 percent of the capital, or over more than 50 percent of votes on the executive board, as well as for other legal entities in which local authorities own more than 50 percent of total revenues.

2.4.6 Control Plan

A budget inspection audit is performed according to the above-mentioned rulebook, and according to a plan which, following the head of budget inspection's proposition, is adopted by the local executive body (the president of municipality or mayor). Additional, extraordinary control can be performed upon request of the executive body.

2.4.7 Control Warrant

Budgetary inspection is performed based on a working plan and control warrant which is issued by the head of budgetary inspection. The control warrant closely regulates the budget inspector for the inspection, the legal entity over which inspection shall be performed, and the subject of inspection and deadline within which the inspection must be done.

The control warrant is delivered to the legal entity before any inspection begins.

2.4.8 Control Process

Before beginning an audit, the budget inspector is obliged to announce the control to the authorized person of the audits' subject. Budgetary inspection will not be announced if it's clearly stated in the control warrant.

Getting to Know the Organization Structure of the User of Budgetary Funds Subjected to the Control

The audit begins by getting to know the legal and statutory regulations of the controlled user.

Normative Regulation of Material Financial Workflow of the User

Control of the normative regulation of the financial workflow of the user consists of checking if the legal entity defined, within its internal actions, an organized accounting system, internal accounting control procedures, persons in charge for legality, accuracy and correctness in reports on changes' creation, as well as deadlines for their submission.

Financial Plan Control and Control of Its Implementation

Keeping in mind that the financial plan is an act of the budget beneficiary which consists of the estimation of revenues and expenditures (including incomes and expenditures from own revenues in the gross amount) for the entire budget year, the control determines if the budget user was observing the adopted plan.

Control of Inventories and Liabilities List

The audit determines if a reconciliation of the books was performed, inventories and liabilities list completed, and if reconciliation of receivables and liabilities was done.

If a budget inspection finds that the legal entity has not made an inventory, or that it hasn't listed its entire inventory, capital, liabilities, incomes and expenditures, or profits, or if accounting records and books are not completed, accurate, updated, or if calculations are not made properly, the budget inspector will, as a result, order restorative measures.

The results shall be made in writing, according to the law which regulates administrative procedure.

The budget inspector sets the deadline for the control's results, which cannot exceed 30 days from the control's conclusion. Any objection must be submitted within three days from the date of receiving the results. The budget inspector decides on any objection within five days of its receiving.

The legal entity is obliged to inform the budget inspector on the results, should the need arise to continue with the inspection after the deadline.

Overview of Assets and Liabilities

Overview of assets consists of:

- non-financial assets (register, list, and calculation of amortization);
- reconciliation of assets value with sources (balance and functional balance between assets and their sources);
- assets and calculation of funds on account and in cash (agreed with data from the Treasury Department);
- register on procurements and gas coupons;
- level of special (restricted) funds;
- availability of temporarily free funds (time deposits, etc.);
- receivables by calculation.

Overview of liabilities consists of:

- operational liabilities (according to the number of account—as per the positions from the rulebook for the charting of accounts for budgetary systems, or according to the balance sheet);
- legal basis for liabilities and deadlines for their payment.

Public Procurement Control

This control checks the procedures of procurement of goods and services and renounces works when the purchaser of those procurements is a state body, organization, institution, or other legal entity set by the Law on Public Procurement (*Official Gazette of the Republic of Serbia* No. 39/2002 through 1001/2005). A control is also performed on the contracts register and other data on public procurements, as well as insuring the legal protection of bidders and others.

Business Trip Expenses Payment Control

Business-trip expenses payment control is performed by checking travel documents and the observation of anticipated expenditures.

Representation Control

Representation control is performed by checking the stated expenditures and specifications of services provided, as well as the observation of anticipated expenditures.

Control over Debt to Banks and Other Institutions

During control procedure checking is performed on the debt of legal entity to banks and other institutions for realizing the level of debt and reasons for it.

Salary Payment Control

Salary payment control is performed according to the instructions on coefficients for salary calculation of persons working in state bodies, public companies, institutions, and other budget beneficiaries. It is performed according to Rulebook on Coefficients for Calculation and Payment of Salaries of the above-mentioned users.

Assessment of Stated Business Results

An assessment of stated business results is performed according to Article 13 of the Law on Budgetary Systems. It concerns financial results (surplus or deficit), differences between the total amount of operating revenues and incomes as based on non-financial assets' sale and the total amount of operating expenditures for non-financial assets procurement.

2.4.9 Record on Performed Control

According to the Law on General Administrative Procedure, state bodies are obliged to act when, during the course of administrative procedure, they directly apply rules, decide on rights, obligations, or the legal interest of persons, legal bodies, or other parties, as well as when they perform other duties set by this law. It is stated that during oral hearings or other important action during the procedure, records shall be kept.

The record consists of findings, conclusions, and if there are some irregularities, suggestions for their elimination.

2.4.10 Additional Record on Given Statements, If Any

Any legal entity subjected to an audit can submit an objection to the findings form record within eight days of receiving the remarks.

If the budget inspector finds the remarks justified, he will make an additional record and submit it to the appropriate legal entity within 15 days of receiving remarks.

If the remarks are not justified, the budget inspector informs the legal entity as such.

**2.4.11 Measures' Implementation Control, and Creation
of an Official Note or Record on Measures Implemented**

The legal entity is obliged, within the deadline set by the record, to inform the budget inspector on their actions regarding the proposed measures and then submit evidence of that action.

The budget inspector, upon receiving that information, performs a check on the proposed measures, and creates an official record of it.

2.4.12 Decisions

If the legal entity doesn't act according to the proposed measures, the budget inspector makes a decision and orders measures, then sets a deadline for the elimination of irregularities.

An appeal can be made against this decision. It must be submitted to the executive body within eight days from the date of receiving this decision.

On the legal entity's appeal, the body in charge will decide within 30 days of receiving the appeal. The decision is final.

2.4.13 Leveling Charges for Offences

The Law on Offenses regulates conditions of offence-responsibility, conditions for recommendations, and execution of offence sanctions, offence procedures, procedure for execution of offence sanctions, and organizations and bodies responsible for offenses and their work.

The Law on Budgetary Systems states that any request for initiating an offence procedure should be submitted via internal controllers, budgetary inspection and audit, local service for inspection and audit, or other persons in charge of the supervision over the implementation of this law.

An offence procedure is conducted according to articles of the law which regulates offenses.

2.4.14 Leveling Charges for an Economic Violation

The Law on Economic Violations is concerned with the general operating rules for imposing sanctions for economic offenses, the sanctions system, as well as the procedure for responsibility determination, and sanctions imposed for the economic-violations executor.

If budget inspector finds economic violations, he is obliged to submit a *report of economic violation* to the public prosecutor, in written or oral form.

2.4.15 Leveling Criminal Charges

The criminal code and criminal law regulates criminal acts, so if there is reasonable doubt, all state bodies, bodies of an autonomous province, or a body of local self-government is obliged to report criminal acts, which are prosecuted officially, and about which they have been informed of, or discover or are found by the record on the control of budget beneficiaries.

2.4.16 Cooperation with Other Inspection Bodies

If the budget inspector, during their control procedure, reveals, or becomes aware of defects or illegal acts which are out of his authorization, he is obliged to report them in writing to the inspection body in charge.

2.4.17 Reporting in accordance with the Law on Budgetary Systems

The Law on Budgetary Systems states that official budgetary inspectors send records on the performed inspection to the minister himself, with both findings and measures. The Minister of Finance then submits an annual report on state budgetary inspection work to the government of the Republic of Serbia, which then submits it to the National Assembly.

Budgetary inspection, or local entities for inspection, submit to the local assembly a record on the performed inspection of budget beneficiaries, for the purpose of gaining knowledge and taking the proper measures within their own authority.

2.4.18 Transparency of the Record on the Performed Control

Besides submitting the record to the local assembly, the audit is discussed in front of the executive boards of budget beneficiaries, and are posted on websites of municipalities and cities.

2.5 Conclusions

As an answer to the question as to what extent the legal framework of local governments provide adequate control of local government financial management, it is as follows: *according to research and stated normative regulations, executive bodies have the possibility to conduct adequate control for the realization of planned goals, maintaining*

funds' integrity, and revealing criminal acts and mistakes, accuracy, and the completeness of financial reports.

An influencing factor on the financial-control implementation of local governments is the control environment, consisting of:

- Executive-board functions and its working bodies;
- business philosophy of management and business style;
- legal-entity organizational structure, and methods for authorization and responsibility determination;
- control systems used by management, including human resources policy and dividing duties.

Recommendations

- 1) Adopt a Law on Internal Financial Control, as soon as possible.
- 2) The Minister of Finance, within his authority, should introduce acts that will regulate standards, organizational criteria, and methodological guidelines, and to closely regulate internal control and internal audit—as soon as possible—so that local governments can do the same.
- 3) Implement a Law on State Audit Institution—as soon as possible—because this law would create an extremely important institution, which would establish a necessary balance between the legislative and executive authorities.
- 4) Harmonize the Law on Accounting and Audit with the IAS, IFRS, ISA, and international auditing standards, and to act according to them.

Audit Function Survey for Ukraine

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1. OVERVIEW OF BUDGET LEGISLATION AND LAWS THAT REGULATE STATE AND LOCAL BUDGETS IN UKRAINE

1.1 Budget Legislation

The Constitution of Ukraine, the Budget Code, and the Law of Ukraine on the State Budget have all contributed to the legal framework for budgets in Ukraine.

The Constitution of Ukraine is the primary law of Ukraine that lays out the essentials of the budget system and the powers and functions of state authorities on all levels.

The Budget Code regulates the relationships arising over the process of the execution, consideration, approval, and implementation of budgets; in addition to the reviewing of the reports on their execution, as well as performing control over the execution of the State Budget of Ukraine and local budgets.

The Law of Ukraine on the State Budget is a document stipulating the revenues and expenditures of the state for public needs, including the size and designation of such expenditures, as well as the division of revenues and expenditures between the state and administrative territorial units.

Other laws regulating the budget's legal aspects, which come up in the process of execution, consideration, approval, and implementation of the budgets and the reviewing of the reports on their execution, as well as control over the execution of the State Budget of Ukraine and local budgets comprise:

- The regulatory acts of the Cabinet of Ministers of Ukraine, executed with the purpose of the implementation of the Budget Code and other laws of Ukraine regulating budget relations;
- The regulatory acts of the central executive bodies, as executed with the purpose of the implementation of the Budget Code, and other laws of Ukraine and regulatory acts of the Cabinet of Ministers of Ukraine that regulate budget relations;
- The decisions made by authorities of the Autonomous Republic of Crimea, local state administrations, self-government bodies made in correspondence with the Budget Code, and other regulatory acts that regulate budget relations;
- Regulatory acts regulating tax legislation and indirectly affecting budget relations.

1.2 Local Budgets Legislation and Intergovernmental Fiscal Relations

The main acts that define the legal framework for the local government budgeting system in Ukraine are the Law on Local Self-governance in Ukraine, the Law on Local State Administration, and the Budget Code of Ukraine.

The Law on Local Self-governance in Ukraine regulates the system and makes guarantees for local self-governance in Ukraine, and acts as a basis for the organization and functioning of self-governments, including the legal status and responsibilities of the local self-government bodies and officials.

The Law on Local State Administrations regulates the organization, powers, and procedures for the activities of the local state administrations, as well as budget relations between the state and local self-government bodies.

The Budget Code regulates the relations between the state and local budgets, and regulates the transfer of funds from region-donors to region-recipients.

The Budget Code, which was adopted in Ukraine in 2001, regulated the budget system, intergovernmental fiscal relations between different tiers of local governments, and clearly specified the main elements of budget control system.¹

The Budget Code regulates all issues dealing with the reviewing, adoption, execution, and approval of their execution reports, as well as the control on state and local budgets.

Thus, **budget control** is a system of authorities and activities aimed at verification of the legality and advisability of activities in the area of formation, distribution, and use of the local self-government's funds. That means that effective control should be maintained at all stages of the budget process.

Based on the Civil Code of Ukraine,² **state financial audit** is one type of state financial control, and one that envisions the examination and analysis of the efficiency and legality of the actual state, public funds and property, other state-asset use, the accuracy of accounting, the reliability of financial reports, and the functioning of the internal control system.

2. ANALYSIS OF THE MAIN CHALLENGES OF THE LOCAL GOVERNMENT BUDGET CONTROL SYSTEM

2.1 State Government Audit and Control of Local Budgets

2.1.1 Types of Budget Control

According to the data gathered regarding main stages of the budgetary process, budget control can be divided into preliminary, current, and final control.

- **Preliminary control** should be performed at the stage of budget formulation, review, and approval. This facilitates coordination of the annual and strategic (medium-term) tasks of the local self-government for economic development; by setting priorities for budget programs and local self-government activities. Under conditions of scarce budget resources, this control should foster efficient and rational ways of the provision of social services and consumption of budget resources.
- **Current control** should be performed during the execution process of the local self-government budget and the budgets of budget-funded entities. It regulates:
 - effectiveness, on the basis of the primary documents—in due order to prevent losses;
 - effectiveness based on performance data and regular reporting—in order to react to the efficiency or inefficiency of economic activities; and
 - adherence to the established norms and policy priorities; and compliance with financial discipline.
- **A follow-up control** should be performed after the budget execution reports and the reports on the execution budget-funded entities' budgets are drawn up; this type of control is exercised during the audit process and general budget evaluation of the financial situation of a local budget. It is aimed at:
 - detecting violations of budget legislation and non-adherence to pre-established priorities;
 - checking the legality of transactions;
 - verifying the reliability of reports;
 - preventing abuse and taking measures to eliminate violations; and
 - keeping government employees accountable.

Table 1.
Main Methods and Uses of Budget Control

Control stages	Uses	Main methods/ways of control
Preliminary	Checking whether the budgetary policy meets national interests rather than political interests; the extent to which the goals of budgetary policy are realistic and feasible (availability of conditions necessary to achieve these goals); economic evaluation of the advisability and efficiency of program-performance measures; their compliance with state priorities; analysis of previous periods; recommendations on funding reserves; control of the established social standards.	Analysis, evaluation, survey, drawing up conclusions, and recommendations
Current	Ensuring that budget appropriations are brought to the notice of spending units; control over the execution of budget-funded entities' budgets; control at the stage of entering agreements and financial commitments; control over payments from budget accounts; and ongoing checks of the effective and efficient use of budget resources.	Tracking, analysis, review of documents, checks of accounts, and inspection
Follow-up	Check of the reliability of reporting data, balance statements, legality of transactions, compliance with legal norms and regulations; evaluation of program-performance measures and efficiency of government activities; analysis of actual consumption and quality of budget services provided; control over the efficient use of the state-owned and municipal property.	Audit, general and ad-hoc inspections, revisions, analysis, general budget evaluation

Internal Control/Audit

Pursuant to Article 26 of the Budget Code, financial control should be executed at all levels of the budgetary process and should ensure:

- continuous evaluation of how sufficient and consistent a budget-funded entity is with the requirements of internal financial control;
- evaluation of the consistency of results with the designated tasks and plans; and
- straightforward information distributed to the senior management of the budget-funded entity on the results of each follow-up (evaluation, investigation, study, or audit) as conducted by the internal financial control units.

Internal controls are rules and systems that allow managers and internal auditors to make decisions on valid and reliable fiscal data. These rules are established within the accounting system and used by managers, but not by the accounting departments.

Spending units shall be held accountable for the organization, internal control, and audit within its own and subordinated units. The senior manager is responsible for an efficient operating system of internal control over the financial and economic activity of the entity.

External Control

External control and audit of the financial and economic activity of budget-funded entities shall be carried out by the Accounting Chamber; the State Budget funds are supervised by the Chief Control and Audit Department of Ukraine, pursuant to its responsibilities as the law prescribes.

During the fiscal year and at its conclusion, at least five sets of several major entities monitor the compliance of local receipts and expenditures with regard to approved apportionments and payments or outlays.

First, the code provides for local verification of budgets approved, apportioned, and implemented by the local governments (Article 115).

Second, the State Treasury, through its regional units also accounts for all revenues and expenditures of local budgets and monitors budget execution to ensure that payments comply with commitments and budget appropriations (Article 112.1 through 3). This is the budget-execution function of the Treasury.

Third, the Accounting Chamber verifies the use of budget funds consistently with the State Budget Law (Article 110).

Fourth, the State Control and Auditing Administration reviews their compliance with accounting procedures and the efficient use of resources by local units (Article 113).

The local state administrations and executive bodies of corresponding local *radas* serve as “supreme audit entities” and provide periodic and final post-audits on the approved budgets, budget apportionment, and budgets of spending units.

2.1.2 Responsibilities of State Government Bodies, Responsible for Audit and Control

There are four major state government bodies responsible for local budgets’ audit and control (see Table 2).

Table 2.
Responsibility of State Auditing Bodies of Ukraine

Accounting Chamber	Ministry of Finance	State Treasury	Chief Control and Audit Department
Controls the:	Controls:	Controls the:	Controls the:
<ol style="list-style-type: none"> 1) use of the State Budget funds in accordance with a law on the State Budget of Ukraine; 2) formation, servicing, and repayment of the national debt of Ukraine; 3) efficiency of use and management of State Budget funds; 4) use of budget funds, which local state administrations are responsible for, and those which are delegated to the local self-government bodies. 	<ol style="list-style-type: none"> 1) meeting the budget requirements on each state of budget process, both for the state and for local budgets (if another is not designated by the law.). 	<ol style="list-style-type: none"> 1) carrying out of the accounting of local budget revenues and expenditures; 2) setting the unified rules of accounting and reporting on budgets' execution estimates, issues the instructions that regulate these issues and controls their observance; 3) correspondence of the disbursement of budget funds, budget obligations, and budget allotments according to the law. 	<ol style="list-style-type: none"> 1) target and efficient use of state and local budget funds; 2) target use and timely repayment of the loans took under the guarantee of the Cabinet of Ministries of Ukraine; 3) accounting procedures and reliability of accounting reports on state and local budgets execution, and budget estimates; <p>Chief Control and Audit Department of Ukraine. Annually submits to the local financial bodies the consolidated results of the reports about the audits conducted.</p>

Aside from these, there are other local bodies responsible for the local budgets' control. The duties of the *Verhovna Rada* (council) and correspondent councils in the sphere of control over the meeting of budget requirements are:

- control over the execution of the correspondent council-decision on the local budget;

- control over the reserve budget fund's use;
- to take other responsibilities, as envisioned by the Budget Code of Ukraine and State Budget Law of Ukraine.

This body exercises control if the approved budget numbers, budget estimates, and budget institution estimates that are made in accordance with budget legislation requirements. The following bodies are responsible for this task:

- The Council of Autonomous Crimea Republic (ARC)—controls the budgets of significant cities of the republic and *rayon* budgets of ARC;
- *Oblasts'* state administrations—control *rayons'* and cities' (of local significance) budgets;
- Local state-administrations in cities of Kyiv and Sevastopol—control *rayon* administrations' budgets in these cities;
- *Rayon* state administrations—control cities (cities of *rayon* significance), village and settlements' budgets and their associations;
- Executive bodies of city councils—control the budgets in cities' districts, villages, and settlements or cities of *rayon* significance, that are under these cities' jurisdiction.

2.1.2.1 *Accounting Chamber*

- *Basic functions of the Accounting Chamber*

The Accounting Chamber holds **external control** in the form of its right to revise and audit.

The audit function is defined as the establishment and analysis of the facts in the process of execution of the State Budget of Ukraine, and their appraisal from the point of view of legitimacy, effectiveness, and appropriateness.

The purpose of the audit is determined by the specific situation and whether or not the budget deals with state-earmarked funds, currency and loan resources, other state funds connected with the State Budget, and its legitimacy, as well as its effectiveness and appropriateness. It further deals with the appraisal of the internal control of the entity being audited, while making proposals to eliminate violations of the law.

The subject of the audit is the *actual procedure* of the use of the State Budget of Ukraine, state-earmarked funds, currency and loan resources, other state funds connected with the State Budget of Ukraine, its movement, regulatory and legal

acts, instructions, and other documents concerning the activity of budget process participants.

The objects of the audit of the Accounting Chamber are the Executive Office of Verkhovna Rada of Ukraine, the Administration of the President of Ukraine, State Administration, the Secretariat of the Cabinet of Ministers of Ukraine, executive office of the National Security and the Defence Council of Ukraine, the Secretariat of the Authorized Representative of *Verkhovna Rada* of Ukraine on Human Rights, the National Bank of Ukraine, authorized banks and other financial institutions servicing funds of the State Budget of Ukraine, the executive offices of Constitutional, Supreme, and the Supreme Economic Courts of Ukraine, other court institutions, central authorities, the executive office of the Prosecutor's General Office of Ukraine, other law enforcement and control bodies of Ukraine, the Supreme Council of Justice of Ukraine, Central Elections Committee, local state-administrations and local self-government authorities regarding their use of the State Budget of Ukraine and other budget institutions, as well as administrators of the State Budget of Ukraine of all levels, other legal entities regardless of the form of ownership in the case of their obtaining funds of the State Budget of Ukraine, state-secured loans; public organizations, political parties, and others regarding their use of the funds of the State Budget of Ukraine and state-earmarked funds, other objects regarding their use of the funds of the State Budget of Ukraine.

Subjects of the audit shall be officials of the Accounting Chamber, persons engaged by the Accounting Chamber to the audit as specialists or experts (see Section 3.1).

- *Regularity of Audit*

The audits can be both ordinary and extraordinary.

- **Ordinary audits** are conducted on the basis of the annual and interim working plans of the Accounting Chamber and its Board, annual and interim working plans of the departments, and other authorized structural divisions.
- **Extraordinary audits** are included in the working plan and conducted upon the decision of the Accounting Chamber Board in cases stipulated by the Law of Ukraine on the Accounting Chamber.

The Accounting Chamber, in the process of State Budget execution, controls the completeness and timeliness of the revenues and actual spending, including those which were directed for financing whole-state-target funds and expenditures on servicing the internal and external debt of Ukraine. It controls all these indicators—actual versus planned.

Therefore, the Accounting Chamber, in accordance with the special templates, submits the actual report about monitoring of the State Budget execution to the

Verhovna Rada of Ukraine on a quarterly basis. This report contains the actual information on the formation of the revenues and expenditures in comparison to the indicators planned in the State Budget of the current budget year, as well as indicators for the correspondent *period* or *quarter* of the previous year.

In order to guarantee the timely processing of the information, which is necessary for the report on State Budget execution, the Accounting Chamber, together with the Cabinet of the Ministries of Ukraine, introduced an obligatory financial-reporting to the Accounting Chamber, from all central and local execution authorities, enterprises, institutions, and organizations. The decisions on specific terms of execution and the forms of their reporting is made by the Cabinet of Ministries of Ukraine, and occurs when the Accounting Chamber submits a request for audit.

The analysis of the operating information, which results from the audit reports, is conducted by the Accounting Chamber, and in a generalized overview, is submitted to the *Verhovna Rada* of Ukraine, its committees, and the Cabinet of Ministries of Ukraine.

- *Who Uses the Reports?*

The conclusions of the auditor contained in a report, which is then approved by the Accounting Chamber Board, and submitted to the audited subject. The latter should notify the Accounting Chamber about any measures taken as a result of the audit report.

If the Accounting Chamber Board deems it appropriate,, the report results will also be sent to the *Verkhovna Rada* of Ukraine and/or its committees, and, if necessary, to the President of Ukraine, to the Cabinet of Ministers of Ukraine, to the Ministry of Finance of Ukraine, and to other central authorities.

If the audit detects data on the of inappropriate use of the budget funds, or other violations implying criminal or administrative liability, the materials of the audit, through a decision of the Accounting Chamber Board, should be filed with the Prosecutor's General Office of Ukraine, other law-enforcement bodies, or with the appropriate court according to the procedure set by the law.

- *Level of Transparency*

Results of the audits are made public through:

- reports and speeches in the *Verkhovna Rada* of Ukraine, its committees, and the Cabinet of Ministers of Ukraine;
- participation in parliamentary hearings and “Days of the Government”;
- the publication of the entire, or portions of the report;

- the issuing and dissemination of information, reference compilations, and bulletins;
- press conferences, briefings, and interviews;
- publishing and highlighting of the statements of the Accounting Chamber members or other executives of the Accounting Chamber in the mass media;
- thematic TV and radio programs devoted to the Accounting Chamber;
- Internet web page;
- Mass-media announcements about materials of the audit considered by the Accounting Chamber Board.

2.1.2.2 *Chief Control and Audit Department (CCAD)*

The CCAD operates within the Ministry of Finance of Ukraine and is under the Ministry of Finance's jurisdiction.

The CCAD divisions in the Crimea Republic, *oblasts*, the cities of Kiev and Sevastopol, are subordinated to the CCAD administration of Ukraine. Control and audit subsections (departments and groups) in the cities' districts, and districts in towns, are a part of *oblast's* Control and Audit subdivisions.

The CCAD co-ordinates the activity with the local population's deputies and executive-power bodies, financial bodies, government tax service, other supervisory bodies, bodies of public prosecutor's office, internal affairs, and their security service office.

- **Basic Functions of CCAD** The CCAD administration of Ukraine is responsible for the following actions in the Republic Crimea, *oblasts*, and cities of Kiev and Sevastopol:
 - Organizing the control and audit subsections in the ARC, *oblasts*, and cities of Kiev and Sevastopol, after conducting of state financial control, summarizing the consequences of state financial control, and in cases foreseen by the legislation, submitting the reports to the executive legislative authorities;
 - Conducting, within the supervised bodies the audits of financial and economic activity, the use and preservation of financial resources, irreversible and other assets, the accuracy in identifying needs in budget funds, and the taking of obligations, status, and the extent to which accounting standards and financing reporting are met;
 - Conducting state financial audits of the implementation of government (budgetary) programs, the activity of budget institutions, the subjects of state management, and other subjects of state management that are given facilities from the budgets of all levels, as well as state funds or their use (when used during a monitored period) by the state or a communal property;

- Providing control after failings and violations identified during state financial control;
 - Developing legal and normative acts as well as instructions on the questions of state control;
 - Carrying out methodological guidance and control after inferior audits and control subsections, summarizing the experience of the state financial control system, and disseminating it among audit and control services, as well as developing suggestions in relation to the improvement of the state financial control system;
 - Verifying government purchases and carrying out other functions in accordance with the Law on the Government Procurement of Goods, Works, and Services.³
 - Controlling the use by political parties of the facilities abstracted from the State Budget which are spent on funding their activities;
 - Examining statements, and complaints from citizens about violations of legislation on financial questions. Appealing reports of thefts, peculation, shortages, and other serious offences; and immediately sending them to the appropriate law enforcement authorities for further action.
 - Controlling the audit and control subsections (departments and groups) in districts, cities, and districts in towns.
 - Auditing and controlling the subsections (departments and groups) in districts, cities, and districts in towns, and performing certain functions envisioned by Article 8 of this law.
- *Regularity of Audit*

The CCAD checks the compliance of the budget execution with the approved budget and other laws, and in case of irregularities, the CCAD may initiate the application of administrative penalties, or hand the case over to the proper law enforcement bodies.

The CCAD carries out scheduled and unscheduled inspections.

For scheduled inspections, the CCAD has developed criteria for the selection of subjects.

Unscheduled inspections (which comprise 19 percent of the total number of inspections) are carried out in response to complaints from citizens and organizations (0.8 percent), requests of government and parliamentary committees (5.4 percent), and at the request of law-enforcement bodies, such as public prosecutors and police

(12.8 percent). In total, 92,000 entities, including 51,000 budget institutions, are controlled every three years.

In general, the process is as follows:

- Planned inspections of budget institutions shall be made not less than once a year.^[1]
- Unscheduled inspections are made based on a set of indicators.

The main motives for unscheduled inspections within the budget intuitions are listed as follows:

- legal requests produced by the president, the Cabinet of Ministries, and Ministry of Finance, which don't require urgent execution without including them into plans;
 - requests of the law-enforcement agencies, legal entities, and individuals;
 - requests of the Accounting Chamber, Ministry of Finance, Ministry of Economy, State Tax Administration, State Duty Service, or the State Treasury;
 - an initiative of the CCAD, based on the following criteria:
 - economic and social importance of the questions, which are included into the programs and action plans of the Cabinet of Ministries of Ukraine for the correspondent period;
 - significant volume of financial flows and other state resources directed for budget-program execution and maintenance of the state bodies;
 - public information about the facts of violation in the financial sphere and ineffective management of state property;
 - probability of data regarding the financial violations, including those which occur due to the absence of the necessary financial control;
 - initiative of the agencies that are under the control, or of their management bodies.
- *Who Uses the Reports?*
- Specialists of the CCAD are obliged to submit audit reports to the appropriate law-enforcement agencies, and inform them if cases of abuse or violations of the law by the state authorities or authorities responsible for state property management have been recorded.

Documents used in the controlling process (official and supportive documents) are to be submitted to the appropriate law-enforcement agency with a cover letter denoting the subject of state financial control.

- *Level of Transparency*

Specialists of the CCAD must guarantee that the commercial and official confidentiality requirements, as defined by the law, are met. This means that the information of the reports is not freely accessible to the public.

2.1.2.3 *State Treasury*

- Basic Functions of State Treasury

In line with Article 48 of the Budget Code, the treasury's form of state-budget servicing requires that a treasury body must perform the following functions:

- cash transactions involving State Budget funds;
- cash-settlement servicing of spending units, including payments based on orders from the key spending units;
- overseeing the execution of budget authorities related to the recording receipts, undertaking commitments, and making payments from budget accounts; and
- accounting for budget operations and developing budget execution, and accounting statements (in pursuance of Article 58, the State Treasury must draw up statements of expenditures based on reports by spending units on the execution of budgets of budget-funded entities by budget entities).

Primarily, this means that the treasury has no right to command or control the use of budget funds. All rights belong to those spending units which have budget appropriations provided for in the law. Treasury servicing is an expenditure control system and a system to make payments. Thus, the treasury concentrates all payment operations of the budget on its accounts, and performs ongoing control at the stage that precedes the allotment of funds from the State Budget, and makes payments from its budget accounts.

Establishing a system of ongoing control over the process of entering budget commitments by spending units requires that:

- those amounts of appropriations that are specified in the Budget Apportionment are brought forward to each budget-funded entity or organization through Treasury bodies;
- each budget-funded entity or organization is given a ceiling of budget commitments within which it may make decisions and enter budget and financial commitments;
- no single contract of a budget-funded organization may be entered without registration with the corresponding Treasury body; it cannot be allowed to enter commitments that obviously exceed the real cash constraints of the budget;

- the contract must be executed; the Treasury should know when and what amount has been paid to the organization's account, and only after the organization confirms that the contract has been executed, the payment can be made.

The accountant of any organization should work along the following lines: the order for payment cannot be issued until goods or inventory items are delivered to the storage facility, and an inventory tag is issued.

The Treasury model allows the state to resolve the main budgetary problem—the problem of accounts payable in the budget-funded sectors—through workable contracts and orders, as well as through monitoring the state's spending. Establishment of a *settlement discipline* is one task of the State Treasury of Ukraine and the treasury system as whole.

Creating a system for the unified accounting of cash transactions ensures the transparency of the budget execution due to timely provision of decision-making bodies engaged in budget management with detailed, reliable, and comprehensive information.

The main advantage of the Treasury's servicing of local budgets is that this approach does not impede the mechanism of local budget execution, but, rather, leads to improved budget discipline and, furthermore, ensures:

- efficient control over the appropriate use of budget funds;
 - accruing funds of the spending units of local budgets on unified treasury accounts of the departments of the State Treasury of Ukraine;
 - transparency of cash flow and control over their appropriate use in accordance with the budget appropriations;
 - unified approach to accounting and reporting on local budget execution;
 - availability of day-to-day data on balances on the accounts of all tiers of budgets and on the accounts of budget-funded entities (before the implementation of this pilot project, said data were only available on a monthly basis—in the monthly budget-execution reports);
 - flexibility in making decisions on budget resource management; and
 - resolution of the problem of intergovernmental settlements.
- *Who Uses the Reports?*

According to Article 80 of the Budget Code, the local budget execution reports are submitted to the relevant *radas* by the Council of Ministers of the Autonomous Republic of Crimea, the local state administration, the executive body of the

relevant *rada*, or the mayor of the rayon-significant city, village, or settlement (if no appropriate executive bodies are created) within two months after the end of the budget period. The report will then be verified by the Accounting Chamber of the Autonomous Republic of Crimea (with respect to the use of funds of the budget of the Autonomous Republic of Crimea by the bodies of executive power) or the budget commission of the corresponding *radas*. Upon consideration of the budget-execution report by the sector commissions and the joint session of the budget commission, the draft decision is considered by the relevant local *rada*. The *radas* shall adopt budget-execution decisions or make other appropriate decisions on this matter.

The quarterly and annual budget-execution reports are submitted to the Supreme *Rada* of the Autonomous Republic of Crimea or the corresponding *rada* by the Council of Ministers, a local state administration, executive body of the relevant *rada*, or the head of the rayon-significant city, village, or settlement (if no appropriate executive bodies are created) within two months after the end of the budget period.

- *Regularity of Audit*

The periodicity, structure, and deadlines for submitting reports on the execution of local budgets is established by the State Treasury of Ukraine, according to the requirements on the State Budget execution in Articles 58-61 of the Budget Code (Article 80.1).

Reports on local budgets' execution and other financial reports are drawn up by regional bodies of the State Treasury of Ukraine, in compliance with the rules and forms established by the State Treasury on the approval of the Ministry of Finance of Ukraine and the Accounting Chamber. Summarized indices on the execution of budgets are simultaneously submitted by regional bodies of the State Treasury of Ukraine, respectively, to the Ministry of Finance of Ukraine, financial bodies of local state administrations, and executive bodies of corresponding *radas*, according to provisions of Articles 58-61 of the code (Article 80.2).

Article 58 contains the following general requirements on the submission of reports:

- summarizing, composing, and filing reports on the local-budget execution are the responsibility of the bodies of the State Treasury of Ukraine;
- spending units, in accordance with the single reporting methodology, shall compose and file detailed reports, containing accounting statements, data on budget execution, results of activities, and other information required by the forms, as established by Ukrainian legislation;

- unified forms of reporting on local budget execution shall be established by the State Treasury of Ukraine by approval of the Ministry of Finance of Ukraine; and
- reporting on local budget execution shall be operative monthly, quarterly, and annually.

Article 59 states that monthly reporting on local budget execution shall be submitted by the State Treasury of Ukraine, corresponding to local financial bodies, in accordance with the following timetable:

- monthly reporting on local budget execution—on no later than the 15th day of the month following the accounting month;
- summarized indices of reports on the execution of budgets, information on the execution of protected items of the local budget, and on the use of money of the reserve fund, shall be submitted by the State Treasury of Ukraine on no later than the 25th day of the month following the accounting month. The report on budget debts shall be submitted no later than on the 15th day of the second month following the accounting month.

Article 60 defines the components of the quarterly report on the local budget execution:

- report on the financial status (balance sheet) of the local budget;
- cash flow report;
- report on the execution of the local budget;
- information on the status of the debt of the Autonomous Republic of Crimea or local self-government;
- summarized indices of reports on the budget execution; and
- report on credits and operations related to state guarantees of commitments.

In pursuance of Article 80.3 of the Budget Code, collection bodies must file the following reports to local financial bodies:

- monthly report on actual receipts of taxes, fees (obligatory payments), and other budget revenues, and a monthly report on tax arrears, including the outstanding and overpaid amounts (broken down by industry and region, as well as by revenue source and ownership form), no later than the 12th day of the month that follows the accounting month; and
- quarterly report on losses in revenue resulting from tax exemptions, on the amounts of restructured and written-off debts (broken down by industry and region, as well as by revenue source, and ownership form), and the amounts

of deferred and spread payments, no later than 35 days after the end of the quarter.

Article 61 of the Budget Code establishes the structure of the annual report on the execution of the local budget:

- report on financial status (balance sheet) of the local budget;
- report on execution of the local budget;
- cash-flow statement;
- information on the execution of protected expenditure items of the local budget;
- report on arrears;
- report on the use of the reserve fund of the budget;
- information on the status of the debt of the Autonomous Republic of Crimea or local self-government;
- report on credits and operations related to the state guarantees of commitments;
- summarized indices on execution of budgets;
- information on the execution of local budgets; and
- other information recognized by the Council of Ministers of the Autonomous Republic of Crimea or relevant local *rada* as required for further explanation of the reported data.

When completing the forms for financial reporting on operations in kind, amounts shall be expressed in the national currency. Importantly, reports shall contain data on both revenues and cash expenditures in the full amount.

In case the Treasury form of budget execution is applied, monthly financial reports shall be checked and sanctioned by the body of the State Treasury of Ukraine (with which registration accounts of the entity are opened) for conformity of the data of the Treasury accounting; the report shall be signed and sealed.

The bodies of the State Treasury of Ukraine and spending units shall be held responsible for the credibility of the data in the forms of financial reporting and their conformity with the data of the bodies of the State Treasury of Ukraine.

- *Level of Transparency*

Officially, the reports of the State Treasury should be submitted to the legal entity or individual upon their special request, in this case the legal entity or individual needs to provide justifications as to why they need the specific reports of local

governments. However, in practice, it is difficult to obtain this report, if one has no special contacts in the government.

2.1.2.4 Ministry of Finance of Ukraine

The Ministry of Finance of Ukraine shall verify compliance with budget legislation at each stage of the budget process with respect to both the state and local budgets, unless otherwise stipulated by legislation of Ukraine.

2.2 Audit and Control Provided by Local Government

2.2.1 Intergovernmental Fiscal Relations System

The Budget Code divides expenditures between the budgets based on the following principles:

- maximum harmony between the expenditure assignments for the provision of budget services and the tier of government responsible for legal regulation, financial support, and provision of these services (principle of relevance);
- concentration of budget expenditures on specialized types of social services at the *oblast* level to facilitate the preservation of budget resources (economies of scale).

Expenditure assignments related to the maintenance of the constitutional order in the state, state integrity and sovereignty, independent litigation, as well as other assignments provided for under the Budget Code, and included in this group, are funded exclusively by the State Budget of Ukraine, and cannot be delegated to the Autonomous Republic of Crimea or any local government.

The Budget Code establishes the responsibility of the central government for funding state social programs. The funds for implementation of these programs are transferred to the local level via a mechanism of targeted subventions from the State Budget.

Thus, according to Article 102 of the Budget Code, expenditures of local budgets for the implementation of governmental social-protection programs (benefits for veterans of war, welfare for families with children, additional payments to the population to cover payments for housing and utility services, compensation payments for reduced-fare transportation of certain categories of citizen), are funded at the cost of subventions from the State Budget of Ukraine in accordance with the procedure established by the Cabinet of Ministers of Ukraine.

In order to assure a better efficiency, expenditures of the State Budget may be passed on to local budgets along with those defined as *local* by the Ukrainian law. Expenditures of local budgets are funded at the cost of the assigned revenues taken into account in defining the amounts of intergovernmental transfers and transfers from the State Budget.

To provide financial resources for the expenditure assignments delegated to local budgets, the state cannot delegate to the Council of Ministers of the Autonomous Republic of Crimea, or local self-governments, any expenditure assignments, unless budget resources (in the form of assigned national taxes, fees, mandatory payments, or shares thereof, or transfers from the State Budget of Ukraine) are passed to them. At the same time, the Council of Ministers of the Autonomous Republic of Crimea, local state-administrations, executive bodies of local *radas*, and the heads of settlements, villages, and cities (where relevant executive bodies are not available) must ensure the execution of the delegated expenditures.

Before the adoption of the Budget Code, it was possible for a higher-tier local *rada* to decide upon the sources of funding for one or other entity, and these decisions usually changed from year to year. Therefore, local governments were not motivated to develop such entities. Moreover, they were not interested in analyzing their efficiency and usefulness to the territory. Article 86 establishes clear criteria for the division of expenditures among local budgets (see Table 3).

Table 3.

Criteria for the Division of Types of Expenditures between Local Budgets
Established by the Budget Code

First group	
Expenditures for financing those budget-funded entities and activities that provide essential social services guaranteed by the state, and are located as close to the recipients as possible (funding of purely local entities and activities).	Budgets of <i>rayon</i> -significant cities, settlements, villages, and their consolidated groups.
Second group	
Expenditures for financing those budget-funded entities and activities that provide primary social services guaranteed by the state to all the citizens of Ukraine (funding of entities and activities for the entire population of <i>rayons</i> and <i>oblast</i> -significant cities).	Budgets of cities of republican (in the Autonomous Republic of Crimea) and <i>oblast</i> significance, and budgets of <i>rayons</i> .
Third group	
Expenditures for financing those budget-funded entities and activities that provide social services guaranteed by the state to particular categories of citizens of the whole region (funding of specialized entities and activities for particular categories of citizens that can be effective only within an <i>oblast</i>).	Budget of the Autonomous Republic of Crimea <i>oblast</i> budgets.

As budget services are assigned to particular tiers of government, local governments are motivated to provide better services and optimize the distribution of budget funds across the types of services with account for the needs of citizens of each particular territory. Besides, money can now be spent for the development of the local budget-funded entities without fear that next year these entities will be funded by another budget.

One major goal of regulation of intergovernmental fiscal relations is to provide the established expenditure mandates of local governments with adequate budget resources. In order to achieve this goal, expenditures of local governments are divided into those taken into account in defining the amounts of intergovernmental transfers, and those not taken into account for that purpose. This division takes place only at the stage of budget formulation, and is used for calculating the amounts of intergovernmental transfers from one budget to the other, in accordance with the Budget Code. This division, however, does not mean that local governments are deprived of independence and freedom in making decisions with regard to budget expenditures in the process of formulation and passage of local budgets. The general view is that the central government is responsible for the financing of the expenditures taken into account in defining the amounts of transfers and reserves the control over the efficiency of these expenditures.

Articles 88, 89, and 90 of the Budget Code establish a clear division of expenditures between the tiers of government.

In accordance with the established division criteria, the Budget Code assigns special lists of expenditures to each tier of government, which are executed on a permanent basis, and taken into account in defining the amounts of intergovernmental transfers. Articles 88 and 89 of the Budget Code clearly establish the types of expenditures to be executed from the budgets of villages, settlements, *rayon*-significant cities, and *rayons*, and taken into account in defining the amounts of intergovernmental transfers.

Expenditures left by the state to the discretion of the local governments, which, therefore, are not taken into account in defining the amounts of intergovernmental transfers, primarily include those for the maintenance and development of communal infrastructure in populated areas—activities related to the development of housing stock, repairs and maintenance of streets, refuse collection, etc. The expenditures that the state leaves to the discretion of local governments are specified in Article 91 of the Budget Code, and the local governments make independent decisions as to their necessity, structure, and amounts.

The main resource for the expenditures specified in Article 91 of the Budget Code are the revenues that are not taken into account in defining the amounts of intergovernmental transfers (the so-called Basket 2). Therefore, the levels of amenities, utility services, and own social programs of territories depends upon the mobilization of these revenues.

Village, settlement, and city *radas* may delegate expenditures for the implementation of all or some of their own assignments to *rayon radas*, or the *radas* of other territorial communities subject to the simultaneous transferring funds to the relevant budgets, in the form of intergovernmental transfers. The possibility to pool budget resources, with

the view of funding joint programs, facilitates mutually beneficial activities, which are otherwise inefficient, if not impossible.

The Main Tenets of Local government Revenue Formation

Provisions of Article 61.4 of the Law of Ukraine on Local Self-governance in Ukraine, declare that “independence of the local budgets is guaranteed through their own and nationwide revenues assigned by law on a stable basis....” At the same time, according to the Law of Ukraine On the Budget System of Ukraine (Article 15), which used to regulate these issues, before the enactment of the Budget Code, the shares of main taxes payable to city budgets (*rayon*-significant cities), budgets of settlements and villages were established by higher-tier (*rayon*) *radas* and changed every year.

Articles 64, 66, and 69 of the Budget Code established the list of revenues assigned to various tiers of government with specification of types of taxes and fees assigned to their budgets.

One undoubtedly positive accomplishment in the formation of local governments’ revenue sources is the fact that the Budget Code not only stabilized the lists of revenues for local budgets, but also fixed their sharing rates between different tiers of government. A higher-tier *rada* no longer has the right to establish the share of any tax payable to the local budget, as these are now established legislatively.

The revenue structure of each local self-government budget is not random—it includes primarily taxes and duties collected on a residence basis. One of the fundamental principles of public finance is that only taxes paid by local citizens should be used for funding social services received by these citizens. The list of local taxes is consistent with international practices and demonstrates a close link between the amount/place of payment and the level of services that a taxpayer (who, at the same time, is a voter in his/her constituency) receives for this money. Local taxpayers are much more inclined to take interest in expenditure-related decisions by local governments and track implementation of these decisions, when they know that these decisions are implemented mainly at the cost of the taxes they pay.

Division of Revenues of the Local Budgets into: Those Taken into Account in Defining the Amounts of Intergovernmental Transfers, and the Ones Not Taken into Account for Those Purposes

An important element of a local self-government system is that of creating incentives to increase revenue efforts, which will help local governments to finance the services they are responsible for. The most difficult problem inherited from the old system was the lack of interest on behalf of local governments in increasing their revenues. Any efforts to increase local revenues or activities aimed at the reduction of expenditures were offset by an automatic cut in the portion of shared taxes or transfers available to the local government.

The Budget Code divided local budget revenues into those included in the calculation of intergovernmental transfers, and those excluded from this calculation. The Budget Code introduced a concept of the “local self-government revenue basket” for the budgets of territorial communities (villages, settlements, and their consolidated groups). The *revenue basket* is a set of revenue sources assigned to the budgets of local self-governments on a permanent basis, and included in the calculation of transfers to these budgets (Article 64.2).

The revenues taken into account in defining intergovernmental transfers are those assigned by the state to a local budget to finance the expenditures calculated on the basis of the norms of budget sufficiency. If the amount of said revenues is less than the amount of expenditures delegated by the state, and calculated according to the formula, a transfer is given to the local budget (equalization grant) from a *rayon* budget to cover the difference.

Revenues not taken into account in the calculation of intergovernmental transfers are those that are fully retained by the relevant government, and not taken into account in defining the amounts of equalization grants (positive and negative equalization transfers). These revenues are meant to be used to finance the expenditures delegated to local governments, in full, as prescribed by law. The composition of the so-called “second basket” revenues is defined in Article 69 of the Budget Code of Ukraine. The structure of own local self-government revenues includes receipts of local taxes and fees, enterprise-profit tax paid by municipally owned enterprises, 60 percent of land tax (for budgets for *rayon*-significant cities, villages, and settlements), as well as revenue sources of capital budgets, along with other revenues as defined by the Budget Code.

The functions of budget control are divided between state and local budgets, in accordance with the division of responsibilities for budget allocations. Expenditures of the local budgets, which are delegated from the state, which are equalized by an *equalization grant*—are controlled by the state. Transfers from the State Budget (budget subventions) are under state control.

Expenditures which are of the local responsibility, which are not financed or co-financed by the state, are the expenditures which are under local government control. However, there are certain restrictions even in this kind of spending (see Chapter 2.2.4, Local Governments: Reasons for Transparency and Accountability).

2.2.2 Audit and Control Functions of Local Government

The audit and control functions of local government are the functions of internal financial control. According to the Article 26 of the Budget Code, the **internal financial control**, which is carried out at all stages of budgetary process, must provide:

- 1) a permanent estimation of sufficient and accordance-of-activity of the budget institution to the requirements of internal financial control;
- 2) an estimation of activity on the accordance of results with the set tasks and plans;
- 3) information from the head of the budget institution about the results of every verification (estimations, investigations, studies, or revisions) conducted by a subsection of internal financial control.

The head of the budget institution is responsible for organization of an effective internal checking system, following economic activity of this establishment, and with an account including:

- 1) positions of this Budget Code and other legal normative acts;
- 2) requirements of purposeful, effective, and efficient management by the functions of every structural subdivision, a correct differentiation of functional duties;
- 3) rules of record-keeping and control in relation to assets, passive voices, profits, and charges of budget institutions;
- 4) providing of accordance of the activity of the budget institution with the requirements of internal financial control.

Managers of budget institutions carry the responsibility for the organization and condition of internal financial control and audit, both in the institutions and within the jurisdiction of budget institutions.

In practice, however, in spite of the legislation requirements, the majority of local budgets which are executed with violations is quite high (from 60 percent up to 70 percent). These days, local councils are unable to prevent these violations, because they don't yet have the necessary tools.

The problem lays in the contradictions between different legal acts, such as the Budget Code, the Law on Local Self-governance of Ukraine, and the Law on Local State Administrations. Based on these three documents, there is some duplication of the functions for budget execution and controlling on each level between local self-governments, executive authorities, and local state administrations, which are the authorities from central government control.

In Ukraine, the reform of financial control, as an element of financial management, is far behind from the reform of intergovernmental relations. The current system of intergovernmental relations in Ukraine requires the development of understood performance measures of the delegated functions for control over the subject, and effective use of budget funds.

The assessment of the budgets' execution for all tiers of government provides an opportunity to better define certain misunderstandings, which are caused by: the lack

of the legislative norms for local self-governance and executive authorities on the stages of budget formulation and execution; the lack of a permanent control over the subordinated institutions and organizations; no effective preventive measures of ongoing control; and the many problems caused by non-cash forms of settlements. Typical violations for the regions are the non-observance of the procedures of distribution of the revenues between local budgets of different tiers of governments. Additionally, it should be noted that the volume of funding from the local budgets the institutions, which should be maintained by the state funds, are growing, in violation with the Budget Code.

One of the major problems of the establishment and development of efficient financial *local internal control* in Ukraine is the scarcity of institutions that could guarantee its effectiveness and efficiency in each of the separate regions. According to the Cabinet of Ministries' Resolution on Ordering of the Structure of the Local State Administrations in the Structure of the Administrations, separate divisions are not yet envisioned.⁴ In practice, the situation with the organization of internal control differs depending of the regions. In most of the *oblast* state administrations, within their structural divisions, there are both control and audit sections established; in certain *oblast* administrations the functions of the internal financial control are performed by the subdivisions that are also part of the line ministries; in some cases these subdivisions or sections are not created at all.

Thus, the local self-government authorities don't have enough legal procurement and financial basis for making decisions on the establishment and development of the system of local internal control.⁵

2.2.3 Audit of Municipal Companies

According to the legislative requirements, the procedures of the internal financial control for the ministries and other executive authorities are developed by the Chief Control and Audit Department. Based on the resolution,⁶ the Cabinet of Ministries of Ukraine **recommends** to the local-self government bodies the procedure of internal financial control of the municipal enterprises. The procedure of internal financial control is defined in the resolution. Practically, however, this kind of control is an *external control* by nature, because it is initiated by the state-controlling authority—the Chief Control and Audit Department.

In accordance to the Law on Local Self-governance of Ukraine, the internal control shall be performed by the authorities of local self-government bodies. The relationship of the local-self government bodies with the municipal companies that are owned by the correspondent territorial community, are based on the principles of subordination, accountability, and are under control of local self-governments.

The Law on Local Self-governance of Ukraine,⁷ notes that the management of municipal companies that are owned by the local self-government authorities, is performed by the village, settlements, and cities' *radas*.

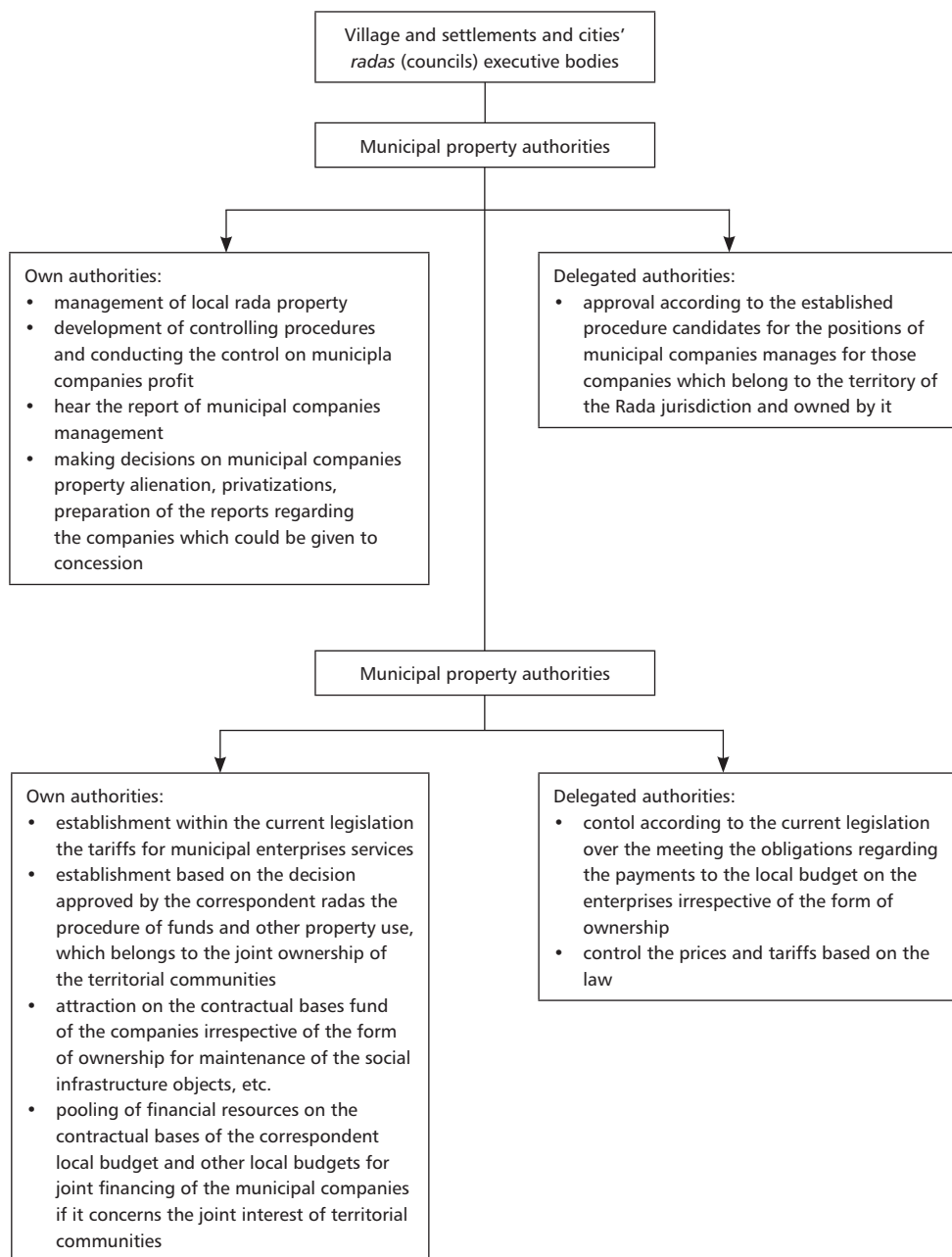
The exclusive competence of the village, settlements, and cities' *radas* are:

- establishment of the municipal companies, institutions, and organizations, that are owned by the correspondent territorial communities, of the share of the profit that will be dedicated to the local budget;⁸
- approval of the decisions on property alienation, according the Law of Ukraine on Transferring the Objects That are under State and Municipal Ownership;⁹
- approval of the local programs of privatization, as well as the list of objects of communal property that are not the subject of privatization; defining the expediency, procedure, and conditions of the privatization of the objects of communal property; making decisions about the acquisition of privatized property, according to the defined legal procedure; decision on including the objects of communal property, which were alienated in the course of privatization (which were based on an invalid agreement); decision on giving into concession the objects of communal property; on establishment, liquidation, and conversation of municipal companies, institutions, and organizations of the correspondent territorial community;
- making the decisions regarding the transfer to other bodies the appropriate authorities, as to the management of municipally owned property of the correspondent territorial community, defining the measures of these authorities and conditions of their performance;
- creating (for necessary situations), the bodies and services which could guarantee together with other subjects of municipal property the joint funding of the municipal companies.

Communal companies' controlling functions are performed by the villages', settlements', and cities' *radas*' executive authorities. Those functions, based on the Law on Local Self-governance of Ukraine, concern the regulation of the budget, finance, and pricing issues of the communal property management (see Figure 1).

Controlling functions are divided into own functions of local self-government body and the delegated functions¹⁰ from the state. Therefore, the authorities of the local self-government body are divided into own authorities and those delegated from the state.

Figure 1.
Municipal Property Management Authorities of Village and Settlements' *Radas*
Executive Bodies



2.2.4 Local Authorities: Reasons for Transparency and Accountability

Internal financial management and the internal budget control as the integral part of the local financial management system could be implemented on the initiative of the local management. However, this type of control mostly concerns the control over the own revenues and expenditures of the local self-government bodies (for those, which are not taken into account while calculating intergovernmental fiscal transfers, see Section 2.2.1, Intergovernmental Fiscal Relations System).

Own revenues are the revenues for which local self-government is responsible, and which the central government doesn't cut. Therefore, local self-governments are usually interested in increasing the volume of these revenues, because it is through these funds that the municipality can finance the development of the municipal infrastructure, by building new hospitals, bridges, improving city roads, and funding additional local social programs, etc.

The Budget for the Development Fund is formed of the own revenues of local governments. This fund is designated to be spent for any municipal developments, such as capital investments.

According to the Budget Code of Ukraine, the Budget for Development is formed by the following revenues:

- proceeds from the sale of communally owned assets, including from the sale of land plots;
- land used for non-agricultural purposes;
- receipts of dividends paid on the territorial community's stake in stocks, or shares;
- statutory funds of business entities;
- proceeds from the repayment of loans provided from the relevant budget prior to the enactment of this Code and interest paid for use of these loans;
- resources transferred from the other part of the local budget in pursuance of a decision;

Made by the relevant *Rada*;

- borrowing raised which is consistent with the procedures provided for under this Code and other;
- laws of Ukraine (except for cases provided under Article 73 of this code); and
- subventions provided from other budgets for the implementation of investment projects.

The Budget for Development could include the following expenditures:

- repayment of the principal of debts of the Autonomous Republic of Crimea and local self-governments (except for debt arising as described under Article 73 of this Budget Code);
- capital investments;
- contributions of authorities of the Autonomous Republic of Crimea and local self-government authorities related to their stakes in statutory funds of business entities.

The reasons that the municipality could be interested in having an internal audit and paying for independent external audits, in practice, are *economic development* and *capital investments*. Therefore, the municipality is interested in attracting foreign and domestic investors, as well as local municipal borrowings that would be spent for capital investments.

According to Ukrainian legislation, there are a set of requirements, established by the Ministry of Finance, for the municipalities that want to borrow money from banks or capital markets. One of the requirements is that the municipality needs to purchase a *credit rating* from a nationally or internationally recognized agency. In order to get a rating, the municipality usually hires an independent local auditing company to collect all the necessary information. Usually, these kinds of services are affordable for the municipalities with a budget of no less than UAH 200 million. Municipalities which have a smaller budget usually cannot afford paying for these services.

Another reason for internal control could be the mayor's interest in attracting foreign investors, who prefer having transparent budget information on the municipality in which they operate, and prefer to read budget reports in an investor-friendly format.

3. ASSESSING THE CAPACITY OF INTERNAL AND EXTERNAL AUDITORS

3.1 External Auditors

External audits of the financial and economic activity of budget-funded entities are carried out by the Accounting Chamber (see Section 2.1.1, Types of Budget Control). According to the amendment to the Constitution that came into effect in January 2006, the main goal of the ACU is to control the revenue and expenditure of the State Budget of Ukraine on behalf of the *Verkhovna Rada* (Parliament of Ukraine). The ACU Act establishes the ACU as a control body, subordinated to Parliament, and operating independently of any other state body, and only accountable to the Verkhovna Rada.

3.1.1 Adherence to International Standards

In 2001, the ACU established a division of internal standards, analytics, and development, with the objective of improving the effectiveness of the ACU's work. This division is currently staffed by 17 employees. The goal of the division is to prepare internal guidelines, give advice to auditors in the preparation and conducting the audits, and comment on the final audit reports from a methodological point of view. The establishment of this division shows the importance given to the development of ACU audit methodology. The division has already prepared a large package of 31 instructions and guidelines for auditors. These documents contain a set of procedures related to the organization of work, preparation of reports, and management letters, etc. The most important of these is the Accounting Chamber's standard-procedure for the preparation and performance of audits and the drawing-up of their results.¹¹ The package also includes temporary guidelines for an effective audit, combining elements of legality and regularity with economy, efficiency, and effectiveness. Further developments, however, in this respect are still needed, particularly with regard to more detailed guidelines focused on field auditing standards and responding to the question of "how to audit" rather than on procedures to follow.

Thus, the existing methodological framework of the ACU audit work is insufficient, as it mostly focuses on procedural aspects. Therefore, further work is needed to adopt the recognized international standards and implement them.

3.1.2 Qualifications of the Auditors and Trainings to Increase their Professional Capacity

Based on the law, the team leaders' groups of state auditors are the auditors who have the control and revision work experience of positions not lower than senior controller-auditor.

The team leader of a group of state auditors (or state auditor, which himself /herself makes the audit of budget institution) should have profound knowledge of the legislation on the financial and economic activity of the budget institutions of specific profiles, profound knowledge of accounting, financial reporting, methods of financial control and audit procedures, the ability to assess the probability of risks of financial violations, have the skills for conducting analysis of financial and economic activity, the ability to define the necessary procedures of state purchases, the ability to make written recommendations as to the elimination of the identified irregularities (violations), and the ability to make an auditor's report.

Other state auditors should have enough knowledge of the legislation on financial and economic activity of the budget institutions of the a specific profile, have

the accounting knowledge and skills, know financial reporting, methods of financial control and audit procedures, and be able to write reports and provide recommendations regarding the elimination of the identified irregularities (violations).

As for staffing issues, the ACU has adopted competitive recruitment procedures and, like other Ukrainian public institutions, has a policy of drawing from a “personal reserve” of potentially good candidates, such as previous ACU employees or experienced employees of governmental institutions.

Professional development programs are based on two systems:

- a system of obligatory training for civil servants, as introduced by the Law on Civil Service, which requires every civil servant to undergo a special refresher training every five years;
- an own training activity, developed by the ACU, which includes training carried out by university departments or professional organizations in the audit area (in Kiev and other cities where regional offices are located). Such a training is carried out based on curricula prepared by the ACU.

A number of Ukrainian educational or professional institutions already offer studies in auditing. In addition, there are training events led by the ACU staff responsible for the development of audit methodology, or IT experts. The training program for 2006 was prepared on the basis of a questionnaire, in response to which all ACU employees specified their training proposals.

The overall intensity of training in 2005 was very high, with 368 ACU staff taking part in various forms of training. These training activities indicate the great attention given by the ACU to staff development. Currently, however, it would be more beneficial to prepare a human resources strategy for the long term, providing specific objectives to be achieved in terms of staff numbers, required qualifications, and promotion schemes. This strategy would include a thorough assessment of the training needs that would provide the natural framework for a specific training strategy.

For the past two years, as part of their obligations as civil servants, ACU staff have participated in an annual performance evaluation, which was carried out in accordance with the Law on Civil Service, and included the employee’s self-assessment of the supervisor’s assessment. A more customized approach by the ACU might be needed.

The key weaknesses of the ACU are its small size and inability to effectively fulfil its mandate, a high proportion of analytical work compared to audit activities, and deficiencies on the methodological side of audit activity, relating, in particular, to insufficient work on regularity audit, as understood by INTOSAI Auditing Standards.¹²

3.1.3 Cooperation with International Organizations

In accordance to Item 12 of Article 6 of the Law of Ukraine on the Accounting Chamber of Ukraine, the Accounting Chamber must cooperate with Supreme Audit Institutions (SAIs) of foreign countries, and respective international organizations, and execute agreements on cooperation.

The Accounting Chamber of Ukraine became an INTOSAI member in 1998. As a part of the realization of the INTOSAI Strategic Plan for 2005-2010, the Accounting Chamber of Ukraine currently takes part in the activities of the INTOSAI Professional Standards Committee (Subcommittees on Compliance Audit, Internal Control Standards, and Accounting and Reporting), INTOSAI Public Debt and Capacity Building Committees, and the INTOSAI Working Group on Environmental Auditing.

The Accounting Chamber of Ukraine became a EUROSAI member in 1999, and takes part in the activities of the EUROSAI Working Groups on Environmental Auditing (EUROSAI WGEA), and Information Technologies.

The Accounting Chamber of Ukraine is the Chair of the Special Subgroup on the Audit of Natural, Man-made Disasters' Consequences, and Radioactive Wastes Elimination, as established by the Resolution of EUROSAI WGEA, in Luxembourg, in 2006.

The Accounting Chamber is also a member of the Council of Heads of Supreme Audit Institutions of the Commonwealth of Independent States, an international organization which nurtures the cooperation and exchange of experience in the sphere of public audit within the post-Soviet area. The second session of the council took place in Kyiv (2001).

The Accounting Chamber developed an involved cooperation with Supreme Audit Institutions worldwide. Currently, the Accounting Chamber has signed Agreements on Cooperation with Supreme Audit Institutions of Poland (1998), the Russian Federation (1998), Bulgaria (2002), Moldova (2001), Belarus (2001), Georgia (2002), Hungary (2004), Korea (2004), China (2004), Lithuania (2005), Slovakia (2005), Armenia (2005), Azerbaijan (2006), and Kazakhstan (2006). Consultations, exchange of experience on methodology and standards of auditing, procedures and methods of the audit, and professional-training and personnel-skills development are anticipated by these agreements.

Fruitful bilateral cooperation in the area of public audit has resulted in parallel and coordinated audits carried out during 2004–2007, by the Accounting Chamber and SAIs of neighboring countries in the field of environmental auditing (with the SAIs of Belarus, Hungary, Poland, the Russian Federation, and Slovakia) and an increased effectiveness of checkpoints (border crossings) at the Ukraine-Poland border.

The Accounting Chamber of Ukraine has been developing, on a regular basis, cooperation with the European Court of Audit, the World Bank, the European Commission, and SIGMA/OECD. Several Technical Assistance Projects were successfully performed in the Accounting Chamber in collaboration with the UN (UNDP “Integrity in Action: On the Way to Public Accountability and Human Rights Protection”), the European Union (“Audit of Public Finances”), and the Swedish Institute of Public Administration.

International cooperation provides for a gathering of new experiences and best practices through participation of our experts in international conferences, seminars, and training programs dedicated to the most important issues of Public Audit.

The ACU takes active participation in international cooperation, in particular, by carrying out parallel audits with other Supreme Audit Institutions. This activity should be continued as it is beneficial for the further development of its working methods.¹³

3.2 Internal Auditors

The State Internal Financial Control in the Ukrainian public administration is currently subject to plans for substantial change. According to these plans, the traditional ex-post control by a centralized inspection service would be replaced by a system based on the principles of the European Union for State Internal Financial Control, i.e., the introduction of managerial accountability for financial management and control, the introduction of decentralized internal audit, and the establishment of a central coordination and harmonization function.

The Ministry of Finance of Ukraine, together with the Chief Control and Auditing department (CCAD), developed the concept of the development of State Internal Financial Control, which was approved by the order of the Cabinet of Ministers of Ukraine on May 24, 2005.

The concept of the *development of state internal financial control over Ukraine* is directed towards the change of the ideology of the financial control over norms and rules of the European Union (EU) and improvements of legal field in the sphere of state-financial control. It also provides for the introduction of new, effective forms of control: internal audit and internal control.

In Ukraine, the basis for local internal financial control is laid down in the Budget Code (Article 26). It defines the managerial accountability for establishing and implementing the local internal financial control system, although still poorly formulated, and not fully supported by secondary legislation. In fact, the concept of decentralized management accounting for local financial control has not yet been introduced in Ukraine.

The system of internal local financial control is not regulated by any specific act. There is a set of legal acts that regulate separate cases, but there is no unified vision for what the local internal control system should look like.

Despite of the fact that some local governments established controlling divisions and sections within their executive commissions, the effectiveness of the work of these divisions and sections is quite low.

The capacity of the internal auditors is also quite low as well, due to the:

- lack of interest of the heads of local administrations to control a greater portion of the local revenues, which is actually controlled by the state. This occurs because of the fiscal dependency of local governments on the State Budget;
- lack of strategic vision and low financial-management skills of the specialists in local executive authorities;
- low financial motivation of the staff of the local administrations, uncompetitive salaries lead to difficulties in hiring a qualified labor force.

Hence, the establishment of the system of internal and external local financial control should be an integral part of the intergovernmental relations reform, which should be accompanied by fiscal decentralization reform.

NOTES

¹ Budget Code of Ukraine (6/21/01) *Verhovna Rada* of Ukraine, No. 2542-III.

² Civil Code of Ukraine (1/16/03), *Verhovna Rada* of Ukraine, No. 435-IV.

³ Law of Ukraine on Government Procurement of Goods, Works, and Services of 2/22/02, No. 1490-III.

⁴ Regulation of the Cabinet of Ministries of Ukraine on the Ordering of Structures of Local State Administrations *Official Bulletin*, 2000.

⁵ I.M. Ivanova, Problems of the Establishment of Municipal Financial Control System. Available online: http://www.niisp.gov.ua/vydanna/panorama/issue.php?s=epol5&issue=2005_3.

⁶ Regulation on Conducting the Internal Financial Control by the Ministries and other Executive Bodies, the Internal Financial Control, Cabinet of Ministries of Ukraine, No. 685, (5/22/02).

⁷ The Law of Ukraine on Local Self-governance in Ukraine of (5/21/97) No. 280/97.

⁸ However, in spite of this stipulation, in practice, the share of the municipal company profit is defined by the Law on State Budget of Ukraine.

⁹ The Law of Ukraine on Transferring the Objects in State and Municipal Ownership (3/3/98).

- ¹⁰ Delegated functions—authorities of the executive authorities, which are the authorities of the local self-government bodies, as well the as the authorities of local self-governments, which transferred to the correspondent local state administrations based on the decision of the *rayons'* and *oblasts'* councils.
- ¹¹ Board resolution of the Accounting Chamber of Ukraine 28-6, 12/27/04
- ¹² Ukraine Governance Assessment Report, March 2006, SIGMA.
- ¹³ Available online: <http://www.ac-rada.gov.ua/achamber/control/en/index>.

Edited by Kenneth Davey, *Making Government Accountable* explores the potential of traditional auditing techniques and institutions to identify where local government funds have gone awry or simply stopped flowing, resulting in poor performance and inefficiencies and gaps in services. This volume also takes a deep look at what role the media and public can play in ensuring the integrity of their town halls and how they can be encouraged to do so.

The result of a thirteen-country survey conducted across Postcommunist Europe, *Making Government Accountable* opens a new chapter on how local government performance and efficiency can be conceived and monitored and reports on a country case basis on what mechanisms are in place, ignored, missing, or being developed from the spectrum of legislative and professional tools that can ensure accountable local government.



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